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# MANAGERIAL ENTERPRISE

Its Growth and  
Methods of Operation

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*By Oswald Knauth*



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## Foreword

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THE INTERPRETATION of modern business here presented is based on personal experience rather than upon established precedent. After twenty years of active merchandising, the urge to return to an interrupted career as economist has proved irresistible. The gap between current business practice and inherited economic theory has been too challenging to postpone any longer an attempt at a solution.

Classical economics has lost touch with the colossal developments of the last fifty years. Words coined in the nineteenth century lost or changed their meaning in the twentieth. Arguments carried on in these terms were akin to shadowboxing. A new framework is called for. Indeed, it is already taking shape.

Reviewing the literature of the last twenty-five years has been a thrilling experience. Economics has acquired a new virility. Many economists are probing into untried and fruitful fields. And it is the writer's hope that this description of the processes by which a managerial enter-

prise is operated may contribute towards sharpening the outlines of this new framework. The change from mercantilism to free competitive enterprise associated with the name of Adam Smith is no more far-reaching than the change from free to managerial enterprise which has been taking shape during the lives of mature men.

The fact that businessmen so rarely write books about their work and experience has often been deplored. But the reason is clear. The task of writing is too time-consuming and exhausting to be fitted into the crannies and spare moments of an active executive life. Arriving at decisions, watching and assessing the daily process, making changes, maintaining the flow of contacts with persons and sources of information—in short, the business life—is too engrossing to leave any surplus energy for the sustained concentration of writing required in the prolonged effort of a book. Again the training and point of view of an executive is diametrically opposed to that of an analytical writer. The former makes decisions, the latter expounds. No mind can fit into both grooves at the same time. The author could not have carried through this book in its many revisions without quitting business in 1943 and giving full-time devotion to the task.

And hence a word of warning. The writer has been called upon to assess ordinary business reactions in fields in which he makes no claim to expertness, as for example, law and labor relations. And above all, no generalization is wholly true but must be qualified. Modern business is governed by a complex of opposing forces and tendencies. Its explanation cannot be simplified. The intricate pattern of personal motivations and impersonal forces defies ac-

curate description and analysis. Opinions will of necessity differ from those expressed in this volume. The limitations, questions, and disagreements raised by those who have read the manuscript make it clear that there will be many more. In the business world it is rare that one can be proven right or wrong. Shades of gray rather than black and white predominate.

Many friends and associates have read and helped reconstruct various parts of the manuscript in its successive phases. Anna Dixwell Knauth has taken part in every phase. Martha Anderson, Addison Burnham, and Dudley C. Lunt have contributed their expertise in clarifying obscurities and maintaining the flow of argument. Among those who have criticized specific chapters are Arthur F. Burns, J. Edward Davidson, William H. Davis, Arnold W. Knauth, Wesley C. Mitchell, Gilbert H. Montague, Barbara Spofford Morgan, Louis B. Wehle, and Leo Wolman.

*PART ONE*

## THE DEVELOPMENT

CHAPTER

1

### Our Evolving Economy

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THE PHILOSOPHY of competitive free enterprise dominates the thinking of the modern businessman. Free enterprise is as universally praised as monopoly is equally condemned. And where the latter is found to exist, it is either made subject to regulation or is broken up. These concepts are simple and clear. They derive from over a century of classical economics and legal doctrines. Yet, in recent years their application has caused a confusion that has troubled businessmen, lawyers, and economists. Many common business practices receive the epithet "monopolistic" simply because

they are not in accord with the accepted rules of free enterprise.

The truth of the matter is that businessmen, in meeting the exigencies of the modern world, have fashioned a new form of economy. This new form is embodied in the phrase "managerial enterprise." It is characterized by neither the competition of free enterprise nor the complete control of monopoly. It is peculiarly a product of American genius. For well over a generation, businessmen without ultimate aim other than survival have bit by bit, in adapting themselves to new conditions, pieced together this new form of economy. Managerial enterprise is a system of production and distribution, unified by policies and controlled by managers, whose main idea is to administer the business that concerns them in the interest of continuity.

The contracts and arrangements which businessmen make from day to day seem to them wise, prudent, sound, and inherent in the nature of modern business. When their practices receive legalistic interpretations and are denounced as monopolistic, they are puzzled. What has hitherto been deemed eminently proper and ethical now subjects them to unexpected criticism and opprobrium. In all sincerity they believe that they are acting in the spirit of free enterprise. Conscious of the limitations which circumscribe their efforts, they are only too acutely aware of how far their powers fall short of those that characterize a true monopoly.

The limits of the antitrust laws are vague and businessmen know not at what point they may overstep them. Hence, they employ counsel for their protection. These precautions only too often fail. In consequence they find themselves enmeshed in long-drawn-out lawsuits, which

may result in convictions. Economists, noting the gap between concept and practice, coin names for the various shades of competition. They qualify it with the adjectives perfect and imperfect or monopolistic. They distinguish between monopoly, duopoly, and oligopoly. The net effect of this is a vague implication that competition is no longer free.

This clash between business practice on the one hand and legal interpretation and economic theory on the other is explainable. The goals of competition and of monopoly are simple whereas the objectives of managerial enterprise are multiple. And to achieve them, policies are adopted that are contradictory or limit one another. No policy can ever be fully carried out. The plain fact of the matter is that the familiar formulas that describe free enterprise and monopoly are not valid when they are applied to much of business as it is done today. The old catchwords and assumptions do not fit this new setup.

During the latter part of the nineteenth century and at an accelerated pace in this one, this new form of economy based upon integrated systems of production and distribution has taken root and prospered. The growth of managerial enterprise, its characteristics, its modes of operation, and its impact upon other economic, political structures are among the most complex and fascinating phenomena of our time. It has its own rules and they differ from those that govern either monopoly or competition. So intricate and so entwined and so frequently at odds are the economic forces that condition its existence, that no single statement with respect to managerial enterprise can fully represent the facts. They are always subject to qualification. Because of

its creeping growth it is ordinarily regarded as a variant of competition. Yet, in rare instances only has it concentrated such power in its hands that it might properly be classified as a monopoly. The theory of managerial enterprise is yet to be stated.

The economic and social life of a community is carried on under various forms. The precise form of the economy does not affect production and distribution as much as is commonly thought. Each form harmonizes with the circumstances where it developed. Each has its limitations and advantages. The most primitive was the family or tribal economy. Slavery long determined the typical form in many regions. State control and ownership, monopolies, and various types of socialism have come down to us from ancient times. Feudalism, dominant in the Middle Ages, was followed by a combination of the guild system and state monopoly. Free competitive enterprise has always had its place, reaching its peak in the nineteenth century.

No single form dominates today in the United States. The economy of our time is a blend of several forms. They exist side by side, sometimes in stark purity, more often in various degrees of intermixture. The essence of family or tribal economy was group self-sufficiency. In modified versions this still exists locally. The degree of self-sufficiency is watered down, but a single family or a group of related families often rule certain counties and sections.

Slavery, in the sense of ownership of man by man, has disappeared, but feudalism, in the sense of fealty of man to master and the acceptance of responsibility by the latter,

may be found in many relationships. Not only old family retainers but also faithful workers in enterprises, large and small, give undying devotion to their masters, receiving in return the assurance of support. Indeed political organizations dominated by a boss have a tincture of this feudal relationship.

The characteristics of the guild system were administration of an industry by a small group, self-limited and regulated, coupled with difficulty of entrance, apprenticeship, effective control of quality and price, and a rigorously enforced code of ethics. Some aspects of this type of organization may be seen among labor unions and trade associations. The guild system underlay the philosophy of the industrial codes of the Blue Eagle days in the short-lived National Recovery Administration in 1933.

Collectivism, on a scale greater than the family or tribal economy, dots the pages of history. The word is used here in a broad general sense to connote forms of state ownership or supervision inclusive of all their various manifestations, such as communism, socialism, state capitalism, fascism and regulated monopoly. In his *Legal Foundations of Capitalism*, collectivism is described by John R. Commons as follows:<sup>1</sup>

The economy-theory of the state is the theory of a going concern with its going business, having its roots in the past, its behaviors in the present, held together

<sup>1</sup> Commons, John R., *Legal Foundations of Capitalism* (1924), p. 361; quoted by permission of The Macmillan Company, publishers.

by the hopes of peace, wealth, virtue and the fears of violence, poverty and vice, through the control of which collective action proportions the inducements to individuals to participate in the burdens and benefits of collective power. In short, the economy-theory of the state is the theory of proportioning inducements to willing and unwilling persons in a world of scarcity.

Collectivism is a feature of such government services as the Post Office, the Tennessee Valley Authority and many activities of the Department of Agriculture. It is also a dominating characteristic of those industries which are generally recognized as monopolies and as such are regulated or controlled by the state; for instance, railroads, air lines, electric, gas and water utilities, municipal transportation, and telephone and telegraph companies. If governmental control or regulation, regardless of the degree of its effectiveness, is taken as the criterion, about one-sixth of the gainfully occupied population of the United States lives and works under what may be called collectivism. The chief characteristics of this collectivism are continuity of service and the determination of prices by a competent authority in the public interest. Tasks are laid out for the employees, their hours of work and rates of pay are governed by mass regulations, and their security of tenure and pension is usually at a maximum. In return, fidelity, avoidance of error, and obedience are demanded, and certainly at the lower levels, initiative is not encouraged and may be dangerous. These circumstances, of course, are not absolute but vary from institution to institution and from time to time.

The banking system has been so subject to governmental regulation and control during the last decade that it might properly be added to the list of collectivist industries. Coal mining, although lately nationalized in England, probably cannot be included among collectivist industries in the United States owing to the strength of competing fuels. Obviously the incessant pressure for uniform wages brought to bear by labor organized upon an industry-wide basis has a vital effect here. Such pressure as is exercised in coal mining and only to a slightly lesser degree in the steel, motor, and shipping industries introduces a new uniformity which in turn stimulates an over-all control of production and prices. This new force is still in embryo and is gradually working itself out through a series of compromises.

Free enterprise in the classical sense can function only under certain conditions. The individual must be sufficiently intelligent to know his own best interests and to judge how he can best develop his potentialities. He must be in a position to accept or reject a wage offer, to agree to or to refuse to enter into a contract. He must possess the imagination and capital to create his own job or to enter any trade or profession. He must be able to shift to a more promising field in another industry with little or no loss of capital, to move from place to place, to work or loaf, to prosper or go bankrupt. He must relinquish the security given by others, relying solely upon his own resources and ability. If he fails he can blame no one save himself. Success will be the result of his own effort and the keenness of his wits tempered by the law. The output of such an individual is but a drop in the

bucket without discernible effect upon total production, its nature or the price structure.

While it is true that each entrepreneur taken by himself is of minute stature, about a third of the country's industry is carried on by him and his like. Most farmers and owners of small businesses, stores, restaurants, repair shops, purveyors of special services, most professional men, domestic servants, speculators, traders, commission agents, brokers, and dealers work under this system of free enterprise. The goods they make are not freely reproducible. Their common characteristic is that they are scarce. For the individualized article the market is informal and the dealing in the nature of an auction by way of contrast with more standardized articles such as wheat, cotton, corn, stocks and bonds, vegetables, fruits, and cattle which are sold on exchanges. With respect to both types, however, buyers and sellers come together in the market place to traffic in commodities and transact business. The transactions are usually cash, the amount fixed by shrewd higgling. Each transaction stands by itself. The impersonal market is the master and to its vagaries the individual must conform. The trader epitomizes the psychology of free enterprise.

Within this segment of our economy, prices are a resultant of the pressure of demand and the adequacy of supply. This means that they are fixed from day to day by the great variety of circumstances that affect the market. The prices of most standardized articles are established on the exchanges. Here the initiative is passing continuously from buyer to seller and vice versa, depending upon the general situation and on the particular urgency of the individual either to get rid of his goods and get his hands on cash, or

contrariwise to part with his cash and acquire the goods. The phrases "buyers' market" and "sellers' market" reflect the pressures governing such trading.

Most analyses of price movements and most price indices are based on the transactions carried out on the various exchanges. The reason is obvious. These commodities are so highly standardized that production and prices can be compared over the years. Their relative and shifting importance in household budgets and living costs can be adjusted by proper weighting. For short periods in the same region price indices are valid measures of price movements. However, a word of warning is necessary. They fail to reflect changes either in consumers' habits or in the course of manufacture and distribution occasioned by technological improvements. Furthermore, they are based upon prices of wheat or other raw materials which are determined on free enterprise exchanges, whereas the consumer will buy his bread, or other finished products, at prices which are usually administered. As will later appear, the administered price is arrived at by a process quite dissimilar from that of the free-enterprise exchange. In consequence, the indices may not accurately reflect changes in price levels.

For other commodities produced under free enterprise, the market is less formalized than that for standardized articles. Yet prices are set by the same principles. Real estate is exchanged through a quasi auction. Rarities are bought and sold at auctions or in individual transactions. Here too the competition of other purchasers influences the price asked by the seller, and the competition of other outlets, the offer the buyer is willing to make. Custom plays its part, especially in the price of services. None the less, the fees

charged by most professional men and the charges made by repair shops, when influenced by custom, are subject to change if they get out of line with competitive figures.

Under free enterprise capital equipment per worker is relatively small and fairly mobile. For the purpose of resale its value can be roughly estimated. Farm equipment can be used on other farms. The space requirements of an office or shop are sufficiently elastic to render moving from one building to another not too inconvenient. Fixtures and tools are simple and can be adapted to other uses without serious loss. In small industry single-purpose machinery is rare.

Throughout the nineteenth century flexibility and mobility were typical of most industry. With respect to the free-enterprise sector of our modern economy, where these characteristics still predominate, the familiar classical theories provide today an adequate explanation of its functioning. For it is on the fluidity of capital and short-run considerations that the classical economists formulated their theories of value and of competitive and marginal prices.

So sporadic and isolated were the beginnings of managerial enterprise that students as well as businessmen failed to recognize it for what it was—a new form of economy. Managerial enterprise came into being because in one way or another the older forms of economy proved inadequate to meet the tasks of the times. A breakdown ushered in a chaos with which the methods of free enterprise were unable to cope. None of the older forms of economy measured up to the new requirements. Competition became so destructive that new methods of operation and new arrange-

ments became imperative. In recent years, as urban concentration and standardization have rendered continuous operation more and more essential, the scope of managerial enterprise has extended. Other innovations—mass production, technological developments, improved transportation, national advertising—all these have intensified the necessity and have speeded up the process.

The distinctive features of managerial enterprise are several. First there is a large capital investment useful for a single purpose but of maximum efficiency for that purpose. Then there is action based upon policies formulated to achieve the strengthening of the business. There is the creation of a demand constant enough to permit planned production with prices decided upon in advance as a part of the pattern. Other characteristics are the separation of ownership and management, and the ability to increase production at lower costs. Finally and above all there is continuity of operation.

The development has not been even. Some industries are more competitive than others. Some are more highly integrated. Also within industries companies vary. Some are dominated by an individual or a family. Sometimes the opportunity to be had by a shrewd bargain proves so irresistible that policy goes by the board. The fluidity of capital varies. Some concerns have been forced into new methods without discarding the old. Borderline cases blur sharp distinctions. But similar exceptions cannot obscure the pattern toward which tendencies have been and are converging.

Rooted in the past, managerial enterprise creates daily the conditions of its future. Its main concern is first to sur-

vive, and second to strengthen its trade position. Its actions are primarily governed by long-range policies rather than by opportunism or a desire for the last cent of profit. All organized industry in the United States from the largest to the relatively small is thus administered. This is about one-half of our total economy, a segment approximately the equal of those under collectivism and free enterprise combined.

And it is ordinarily the dynamic segment. It is here that the technical progress, the increases in production and the introduction of new methods of distribution have been of startling effect. The General Motors Corporation in production and Sears, Roebuck Company in distribution are typical of the largest organizations operating in this segment of our economy.

Concerns having specialized one-purpose machinery, such as machine-tool manufacturers, boat yards, canning factories, and department stores in towns, are typical of the smallest. Their common tie is that their stake is in the future rather than the present. Their overhead expenses are high in comparison with their running expenses. They attempt to create the conditions under which they operate, rather than adjust themselves to the impersonal market as the entrepreneur must. In comparison to monopoly, however, their control is limited and more or less temporary. Their operations depend upon continuity, yet this continuity is constantly undermined by changes—technical, economic, social, and political.

In most industries several managerial enterprises have come into being, and in some industries there are many of them. In a sense competition between them is very real and

in so far as it is real, an analogy with the free-enterprise economy is apt. But this competition is not one of individual purchases and sales or of prices alone. Individual transactions play their role not singly, but rather as part of a related series, price being but one among the many factors that determine the market for a product. More influential is the building up of good will and a repetitive demand. Thus the competition has a different character from that of free enterprise since it is aimed at achieving continuity through the creation of a system which will serve with increasing efficiency an ever-widening group of customers.

Nor is this competition confined to the firms within an industry. There is also competition between industries. Motion pictures compete with the stage and with other forms of entertainment—sporting events, the radio, 'concerts, and the night clubs. Each has its audience; each its periods of popularity. Books compete with magazines and newspapers; motor cars with clothes and furniture. At times dramatic changes take place. A commodity will suddenly become obsolete. Fabricated roofing all but put an end to the slate shingle industry. Synthetic nitrate has ruined the market for the Chilean natural product. With the advent of phonographs, music boxes became antiques. Welsbach mantles disappeared before the onslaught of electricity. The silk industry has shrunk to small proportions as rayon and nylon have replaced it in more and more uses and as the technique of manufacture is adjusted to the peculiarities of these products.

The resemblances to other forms of economy have blinded observers to the essentially new methods of operation that have come to be characteristic of managerial en-

terprise. Skillful analysis has been advanced, much of it biased and in the form of either carping criticism or blanket approval. Managerial enterprise has no shining goal—such as the profit motive of free enterprise or the service to the state of collectivism—which might be used as a gauge in judging it. When the rigid formulas of free enterprise are brought forward, the practices of managerial enterprise may be interpreted as antisocial. Big business is suspect, and fear that it will abuse its powers is widely prevalent. Enterprise ceases to be free when any alignment for control vests one group with power. Yet power is intrinsic in managerial enterprise.

Regarded from the collectivist point of view, many practices of managerial enterprise seem wasteful. It is claimed that extensive advertising, free services, changes in design, cross shipping could all be reduced in a collectivist system.

The inequities and failures of the industrial system are under constant popular surveillance. Whether businesses should be broken up and forced to compete in the rigid sense of free enterprise or whether they should be more strictly regulated is a highly controversial issue. An outstanding reason for our failure to solve the economic problems of our day is the tendency of legislators and economic analysts to hark back in their attempts to the familiar premises of free enterprise and monopoly. Managerial enterprise is thoughtlessly condemned because it is judged by the norms of free enterprise or of monopoly.

An understanding of the larger aspects of the problem is beginning. It is seen that the simple theories of free enterprise and of monopoly are insufficient to explain the complexities of managerial enterprise. Slowly and in grop-

ing fashion, ethical concepts and legal attitudes are being adjusted to the changing picture. Forward-looking work is being done in many directions—in government and by scholars and business leaders.

## CHAPTER

# 2

## The Transition from Free Enterprise

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ORDINARILY managerial enterprise has developed from free enterprise. By 1900, large companies, family-owned and family-operated in most instances, had accumulated such an investment that stability of the economy and a continuity of operation were essential to the maintenance of its value. Many individual companies in the steel, agricultural implement, oil, milling, textile, and shoe industries had attained an importance that made them factors in stabilizing the market. As their owners managed them in their personal interests, they had some of the characteristics of free enterprise, coupled with the power acquired through growth. They were on the border line between free and managerial enterprise.

Take the case of J. Ogden Armour. Ray Stannard Baker in *American Chronicle* suggests that Mr. Armour was lacking in sincerity when he proclaimed the gospel of free enterprise. He none the less acted according to the needs of the meat-packing system which he was creating at the turn of the century.<sup>1</sup>

<sup>1</sup> Baker, Ray Stannard, *American Chronicle* (Scribner, 1945), p. 209.

I recall thinking how curious Mr. Armour's position was. On the one hand he commended competition as the only fair regulator of industry, asserting that the law of supply and demand was the only law that could operate successfully in controlling the cattle, beef and fruit business. On the other hand, he was himself, so far as I could learn, secretly doing his best to prevent competition and build up monopoly in every business with which he was concerned. In other words, he wanted free competition for the people who dealt with him, and he wanted unrestricted power to do away with competition when he dealt with them.

Well, I liked Mr. Armour, but it seemed clear to me that his likableness had little to do with the hard problems of social injustice we were studying. One of his strange defenses of his situation, in which there seemed an implied admission of the evils of the system under which he was thriving, was that even if he should step aside the man who took his place would be forced to play the game just as he did. He would still have to meet the competitive practices of other packers.

Pressure of events was compelling every man in Mr. Armour's position to do precisely what he had done. Management had to think in the terms of the morrow rather than of the day. The fixity of capital investment, the pressure of stocks flowing from mass production, the multiplicity of skills that go into making the finished product, the need for continuous distribution, all these demanded an integrated organization. When capital equipment became so large, specialized, and unwieldy that it could not be

moved easily, its value could be extracted only over a period—in most instances several years. To maintain continuity in the flow of raw materials to the manufacturer and of finished products to the consumers, internal and external conditions had to be shaped.

This decline of the self-regulating, impersonal market was not confined to the United States, but was world-wide. The monetary orderliness imposed by the gold standard was crumbling as managed currencies aimed at local stability were instituted in many countries. International balances no longer adjusted themselves automatically. The accompanying political changes were the collapse in many instances of liberal states and shifts in the balance of power. The institutional frame within which the individual entrepreneur had been accustomed to work out his own destiny was losing its strength as a protective shield. Business had to shore up its own bulwarks. It had to safeguard its markets, its sources of materials and labor, and its relations to foreign as well as to domestic competitors.

These new demands could not be met by individual entrepreneurs, each acting on his own. They required a system in which were coordinated all the steps from the extraction and purchase of raw materials to the distribution of the finished product to the ultimate consumer. Long-range planning took the place of the astute judgments with which the entrepreneur met the problems of the passing hour. Success depended more upon carefully considered policies, designed to fit present realities and to allow for future potentialities, than upon the seizure of momentary advantages. Immediate profit was no longer the sole objective. In its place an established trade position became paramount.

Management found that stressing immediate profits led to future losses. Over-shrewdness in driving a bargain with a regular customer aroused antagonism, which might be repaid with interest when the tables were turned. No great managerial enterprise has ever been erected by skillful trading alone. In the long run, value must have been delivered.

The life blood of managerial enterprise is a steady demand. This is sometimes general, but is often localized in a community, class, or group, or in another industry. Chewing gum, soft drinks, prepared goods are consumed by the general public, harvesting machines only by farmers, and locomotives by railroads alone. For each product, however, there is a broad base of demand. In seeking to assure continuity of operation businessmen have found that they had to build up a reputation that would attract and hold customers, have a convenient location, contracts that would ensure sources of material, trade connections, a complete series of services, research departments, patents, and secret processes. Any trade advantage that might be of use was eagerly followed up and cultivated. The goal was to gain over the market as great a control as possible. The number and importance of the trade advantages determined the degree of this control and some degree was ordinarily achieved. This type of control was reflected in the steadiness of demand and volume rather than in the price.

The coverage of this type of demand is constantly spread by advertising in magazines with nation-wide circulations and over the radio. Thereby manufacturers acquaint the entire country with the virtues of their products. Rapid distribution by post, rail, truck, air, and automobile, together with the ability to supply identical products over a wide

area, unify the patterns of demand of urban and rural dwellers in East and West, North and South. The big mail-order houses, chain stores, and some department stores have a national demand for their products that can be forecast. They can place orders many months ahead, and on these manufacturers can count as a backlog for an efficient and economical schedule of production.

Many manufacturers, exasperated by their failure to anticipate the unpredictable orders of wholesalers, assure themselves of a constant market by setting up their own distribution systems. The Coca-Cola Company, oil producers, tire, and radio manufacturers can estimate to a nicety the consumption of each locality. Automobile companies organize intricate systems of distribution that are marvels of efficiency. Standardized services are widely available for the repair of standardized articles. When sales fall below the projected quota, new pressure devices are immediately applied to restore them. Advertising in newspapers and on the radio is intensified. Special inducements are offered. Surveys are made to discover customers' preferences, and then no effort is spared to satisfy expressed desires.

But local and group prejudices run deep and are as difficult to overcome as they are to explain. Regions and groups are partial to certain brands. Utica sheets are popular in one city, Pepperell sheets in another. Pepsi-Cola outsells Coca-Cola in certain localities. It is an expensive and risky process to attempt to break into a market already pre-empted by another dealer. Stocks must be carried and services installed to be ready to meet the demand it is hoped will eventuate. Until that hope is realized, turnover may be so low that products will lose their freshness. Then overhead

expense and wages become disproportionately heavy. Thus before consumer acceptance is won, if it is, many months may have elapsed, and the cost may have been ruinous.

On the other hand, if a product cannot be bought for some time, consumers may switch permanently to another. The habits and preferences of consumers are strong, but they are fickle. Perhaps the most serious effect the war had on some companies was to remove their products from the market. Fear that their products would be forgotten explains their feverish exertions to keep their names before the public.

The circumstances giving rise to managerial enterprise in the United States were also at work in other parts of the world to a greater or lesser extent, especially in industrial countries. But governmental policies have differed. In widespread instances, particularly in England, France, and Germany, government invested in industry on a large scale, contributing a substantial portion, often the bulk of the capital, but usually appointed only a minority of the directors. These "mixed" corporations were common in railroads, shipping, public utilities, and munition plants. They are unknown in the United States, where the policy of the anti-trust acts is to compel competition, especially in prices. The Department of Justice has attacked even railroads on their adoption of the conference method of fixing rates. Although no railroad is permitted to set its own rates, rates between the same two stations on competing lines must be identical, and all rates must be approved by the Interstate Commerce Commission. Relations between management

and government have been at arm's length, if not actually hostile.

With the depression of the thirties, some governmental agencies became more friendly. This tendency grew more pronounced during World War II. Through the Maritime Commission appropriations, the aviation services of the War and Navy Departments, the mail subsidies of the Post Office, the loans of the Reconstruction Finance Corporation, government has lent a helping hand to industry. None the less, managerial enterprises have, in general, remained independent entities.

Everyone who has taken part in the management of an old going concern is impressed with the sheer momentum it has acquired. Orders come in and production goes on as a matter of routine. Driven by constant pressure, the busy executive is occupied with the tasks that flow to him. Each day, each hour brings to him reports, letters, visitors, and meetings. These are problems that require attention and must be settled. Occasionally, he must rise above this mass of detail to examine the operations, tendencies, and policies as a whole.

It is around articles that can be readily produced in any quantity desired and have a widespread demand, that managerial enterprise grows. These may be termed articles of commerce—automobiles, cigarettes, and thousands of others. With these the difficult problem is not production. The vital task of management is that of distribution, and this involves inciting rather than filling the demand. Once a producing unit has been organized, its forces can be guided in one direction as well as in another. Facilities can be expanded, provided the demand is sufficiently strong and per-

manent. When the increase in output can be made at an equivalent or smaller cost, the basis for this economy of plenty has been laid.

One of the fundamental differences between free and managerial enterprise lies in the relation between demand and supply. The free enterprise economy presupposes a scarcity of goods. An increase in demand leads to the utilization of marginal resources and less efficient methods. This tends to raise costs. Prices respond to the rise of costs until they reach a point where the demand tends to decrease. Then a new equilibrium at a higher price is found.

Managerial enterprise, on the contrary, possesses for all practical purposes an unlimited ability to produce the best sellers among commercial articles. When demand seems to be rising, ingenuity is directed toward meeting it. Productive capacity is stepped up, labor-saving machinery installed, mass methods and economies are introduced. This tends to lower costs and prices. Prices are set at lower levels to induce demand and to bring products within the purchasing range of a fresh set of consumers. Renewed efforts are made to find and invent other uses for articles. From luxuries, they become necessities.

The process spirals. Increased use of articles calls for an increase of co-related facilities and services. New industries are born. As they achieve quantity production, they too have lower costs and can reduce prices. The demand for raw materials encourages a search for new and cheaper sources of supply. The quantities bought are so tremendous that transport can be regularized. New skills are developed, employment rises, and output per worker multiplies. This culminates in higher wages, higher returns to capital, and

lower prices. The economy of plenty is ushered in. The struggle for existence becomes a struggle for advantage. A desire for betterment replaces need as the motive power of individual action. The gloom of the classical economist gives way to the hope for an age freed from poverty. And the potentialities seem only to have been tapped.

Despite the shadowy contours of managerial enterprise, which in many instances is but partially matured, it is quite possible to set up a table of contrasts with free enterprise.

#### FREE ENTERPRISE

- Fluid capital
- Flexibility and mobility
- Concern for the moment
- The identity of ownership and management
- Unimportance of the individual entrepreneur
- Action is adjusted to impersonal market conditions
- Increased demand has its main impact upon price
- Costs are estimated accurately
- The goal is immediate profits

#### MANAGERIAL ENTERPRISE

- Sunken capital
- Standardization and a relative rigidity
- Concern for the future
- The separation of ownership and management
- Each unit affects the market
- Market conditions are shaped by policies
- Increased demand has its main impact upon production
- Costs are based upon actuarial assumptions
- The goal is a stable and adjustable system, the functioning of which creates profits

Free enterprise operated under the mythical belief that the acts of individuals were consonant with the welfare of the community. This mutuality of benefit was supposed to be achieved through competition on the free and impersonal market. No such preordained harmony can be claimed for managerial enterprise. At times it seems to pursue policies beneficial to itself but harmful to the community. Indeed, Keynes has argued that economic equilibrium may be achieved at a level lower than the highest of which the economy is technically capable. He points out that the balance of productive forces which management attempts to maintain on an even keel does not necessarily bring about full employment of the working population nor the maximum of output. By this he means that the interest of the individual enterprise does not coincide with the national interest, and indeed may be antagonistic to it. Whether such a criticism can be substantiated can be answered only after examining the structure and processes of managerial enterprise internally and externally. And this is our next task.

## CHAPTER

# 3

## The Change of the Corporate Pattern

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THE CORPORATION originated with a group of owners, the participation of each being reflected in the number of his shares. These shareholders selected from their own number a board of directors. These directors comprised the largest and most capable owners, who in turn, again from their own number, selected the active managers. Thus, management and ownership were intimately bound together. This close relation persists in many private corporations whose stock is not ordinarily sold on the market. Indeed, in some of these corporations, an owner cannot dispose freely of his shares. To a lesser degree, it persists in corporations where the managers themselves own or represent large holdings.

In the amalgamations during the first decades of this century, this close owner-management relationship continued to exist. Many of the family industries that entered into these mergers dominated the amalgamations through their large holdings, thereby extending their power. However, with the passage of time, ownership and management be-

gan to drift apart. The owner-managers were gradually replaced by men selected for their executive ability, regardless of whether they were stockholders. Stock was sometimes divided among children and grandchildren, or sold to the public. When it was held in trust the owner-management concept was again stretched, the trustee becoming a director primarily to watch over the interests which he held for the benefit of others. Later, the bankers who floated issues to the public often became directors in order to maintain contact with the conduct of the affairs of the company. The personal touch between owner and employee that had characterized small concerns was lost. Employees were counted in the thousands, and were scattered in different localities. The new immigrants who furnished most of the unskilled labor came to be looked upon as a race apart.

#### **STOCKHOLDER**

This widespread dissemination of corporate ownership has converted the modern stockholder into an absentee owner. Corporations now speak proudly of their large families. The American Telephone and Telegraph Company boasts of having over 600,000 stockholders, no one of whom owns more than one per cent of the total stock. Many corporations have stockholders running into tens and hundreds of thousands. Even their long lists of stockholders understate the breadth of distribution, for many shares are held by dummy corporations, on whose books the holdings are credited to the individual owners. This anonymity cuts the true owner off completely from management. Not being re-

corded on the books of the company, he receives his reports only indirectly, if at all, and he has no communication or personal relation with management.

Though he may be interested in the enterprise, he cannot find out what is going on. When he anxiously inquires for information beyond that provided in the reports, management is polite, but firm. He is told that his suggestions will be given due consideration, but that he is entitled only to such facts as are made public. The excuse is that the granting of further information would be favoritism and provide one stockholder with inside knowledge unavailable to others. Even for insiders, a correct understanding of all phases of any large enterprise is extraordinarily difficult. Properties may be scattered, and policies intricate, contracts carefully guarded and good will not easy to evaluate. Capital value may appreciate or depreciate substantially before the evidence appears in the balance sheet.

There is a strong tendency to support management blindly. The exception is provided by the case of a few professional obstructionists or reformers. Occasionally an individual will take advantage of his legal right to voice his protest against some policy. But objection is usually futile, and soon forgotten. Many stockholders have such a feeling of frustration that they do not bother even to sign and return proxies. To "get out the vote" for a quorum at the annual meetings of stockholders is difficult. The stockholder usually expresses his lack of confidence in a corporation by selling his shares. He seldom succeeds in having a new management hired. John D. Rockefeller, Jr., is among the few to have made an effective protest and even he, despite his

large minority stock ownership in the Standard Oil Company of Indiana and his great influence, barely succeeded in his campaign to change its management in 1933.

The diversification of investments, though sound from the standpoint of the individual, reduces his need to be actively interested in wise and proper management. Absentee ownership is extended by other circumstances. Investment trusts trade in shares solely for the benefit of their own stockholders. These might be called "hot" shares, for they are always for sale at a price. While an investment trust must publish quarterly a list of the securities it holds, the average stockholder does not compare lists and note the changes. Moreover, in recent years a new profession, the investment counsellor, has arisen, eager to assume responsibility for diverting clients' holdings to the most profitable channels. He is in duty bound to advise the sale of holdings if he deems other investments safer or more promising. Though the evaluation of the business is thus put into trained hands, the concept of ownership as a stake in it is further diluted. From investors who were part owners with active interest in the progress of a corporation, stockholders have thus been transformed into speculators who are claimants on such portions of income as the directors declare in the form of dividends.

#### DIRECTOR

The role of directors of corporations has evolved along several lines. Originally the directors were the working mouthpiece of the stockholders. Their duties and responsibilities were not specifically defined simply because there

/ was no pressing need for sharp delineation. By right of ownership and ability, they were the policy-making management. Such assistance as they needed in management at the lower levels was purchased, just as labor was hired and capital borrowed.

As time passed, in the course of averting bankruptcy, negotiating mergers, or financing expansions, a new type of director was introduced. The financiers who made the arrangements had themselves put on the board of directors. The purpose at first was to establish a contact through which they could keep themselves currently informed about the undertaking. But once the barrier of ownership had been let down, directorships too frequently became the means of obtaining advance information. Favors and back-scratching deals were enormously profitable. It was not extraordinary for a man to be a director in thirty or more corporations.

Many of the reasons for infusing new blood into the board of directors were entirely proper. Lawyers, real-estate experts, officials of other corporations with which the concern had intimate relations might become valuable assets. Certain of the more capable managers who had grown up in the business, even though they owned little or no stock, asserted themselves and became directors. However, with the dilution of ownership and management, private deals detrimental to the interests of the stockholders became more feasible.

Abuses, real and alleged, led to prying the lid off corporate affairs in litigation and Congressional investigations. Finally there was set up the Securities and Exchange Commission. Directors found themselves subject to suit by dis-

grunted stockholders for the company's losses. The business community was startled when the General Motors Corporation and certain of its directors were sued on the ground that bonuses paid officers had been illegal. At first, the case was not taken seriously, for the procedure followed seemed to meet all the requirements. Although the principle of bonuses had been approved by the stockholders and had the blessing of counsel, the court held that bonuses must bear some relation to the value of the services rendered and that otherwise, they constituted gifts. Witness the following judicial utterance in *Winkelman vs. General Motors Corporation*:<sup>1</sup>

If it is shown that there were breaches of duty and the compensation voted in such breaches bore no relation to the services rendered, the directors responsible for voting the compensation may be held personally liable.

The request of the defendants that the case be dismissed was granted only in respect of the bonuses paid in 1931, 1933, 1934, and 1938. In these years they were held not excessive. It was disallowed for 1930, 1935, 1936, and 1937. No bonus had been paid in 1932. Subsequent review resulted in an order by the lower court that the sum of \$4,500,000 be returned by the recipients to the Corporation. Even when directors consider some course of action above reproach, they do not venture upon it if their legal advisers believe it may bring them afoul of the law.

Whether directors should direct or whether they should confine themselves to the selection of management and

<sup>1</sup> 39 Fed. Supp., 826 ff.; also 44 Fed. Supp. 960, and 48 Fed. Supp. 485, 490, 500, 504.

then its critical appraisal is a moot question. As a board of directors is constituted today, it is in no position to manage. The members include large stockholders, representatives of institution-held blocks of stocks, financiers inheriting ancient connections with the corporation, experts of various sorts, and active managers. The last-mentioned group, which is usually about half the total board, are the only members equipped to direct the daily affairs of the enterprise. Indeed, they are the more capable in inaugurating policies as well as carrying them out. But since they make up a large section of the board, it is difficult for the board as a whole to act as an impartial tribunal when their ability is called in question. The other members either lack the time or inclination, or are not sufficiently in touch with the company's affairs to direct actively. However, they are men of wide acquaintance, much experience, and with an intense personal interest, both financial and moral, in the success of the enterprise. Hence they are eminently qualified to appraise, with a sure touch, programs and results. Again, their varied contacts give them a wide range of choice if it becomes necessary to select a new management. None the less, recent developments have tended to push each group into the field occupied by the other. Directors are viewed as responsible for the acts of management, yet managers select directors, thereby perpetuating themselves.

At one extreme are the boards of directors chosen entirely from within the organization. The Standard Oil Company of New Jersey has eleven directors, each of whom has worked his way up from within and was chosen for his proficiency in some branch of operation. To be a managing director of this company is a full-time job. Such directors

are not permitted to have any other business interests. They select, counsel with, and supervise the executives of the subsidiary companies, decide whether to purchase or sell properties and whether to expand or contract operations. The Dennison Manufacturing Company has gone even further in this direction. It has removed the voting power from the shares owned by the public and concentrated it in a small percentage of shares owned entirely by the two hundred top-flight employees. These employees elect the board of directors from their own number, thereby completely divorcing ownership and management. They are required to surrender their voting shares when they leave the company. Both companies are successful. In each case, these employees have had to broaden their vision to encompass the affairs of the entire company, and not devote themselves exclusively to furthering their own interests.

At the other extreme is the board of the American Telephone and Telegraph Company, composed of nineteen members, only two of whom are in the active management. The rest are leaders in industry, finance, and public affairs, selected for their prestige as well as their integrity and ability. They represent diverse interests and viewpoints, rather than unanimity. Between these extremes is every conceivable combination.

A recent innovation is the paid director. Men are picked for their wisdom and experience to study the company's affairs and offer their considered opinions. They may be directors in half a dozen companies, receiving a stipend from each, and engaging in no other activity. The idea has merit. There is a place in industry for the broad point of view

which the busy executive, immersed in his own technical problems, is unable to supply.

#### MANAGEMENT

As we have seen, with the passing of the founder-owner-manager there came the separation of ownership and management. The first generation manager had created his own niche. His name was frequently over the front door. The manager of the next generation owed his position to others. He was selected by the directors for his skill, resourcefulness, and reputation and regardless of whether he owned stock in the company. Frequently, the terms of his employment were set forth in an arm's-length contract. Therein his duties, salary, and other provisions contingent upon his success were outlined. At times, the illusion of ownership, as well as the opportunity for extra benefits, was furnished by an option to purchase stock at a fixed price. Again pension rights might be offered in lieu of a higher salary. The contract was for a year but life tenure was implied and expected.

The appointed manager took over a going concern, with traditional ways of doing things. It was up to him to continue its success and to adapt its policies to technological improvements and to changes in public demand and in social outlook. Unlike his predecessor, the owner-manager, his was not the voice of ownership. His loyalty came to embrace the organization as a whole. He had to decide nice questions about sources of supply, the rights and duties of directors, officers, employees, and customers, as well as of

stockholders. Relations with the public and government came within his purview.

Alfred McIntyre, President of Little, Brown and Company, wrote on the 110th Anniversary of the company:<sup>2</sup>

In 1937, when Little, Brown and Company celebrated its centenary, I had been with the company for not quite thirty years, and I felt then—at least it seems to me now—that I knew most of the answers to our problems—that generally speaking a decision that seemed sound as of yesterday would seem wise as of tomorrow.

I am proud today as I was then of the company's history, and my associates and I are still influenced in our daily actions by tradition, but a decade of world crisis has taught us that, as Benjamin Franklin once wrote, "In this world nothing is certain but death and taxes." Of course we all have beliefs and prejudices; and as Little, Brown and Company is about to begin its 111th year of book publishing I am convinced of this at least—that to increase the retail prices of books percentage-wise to match increased costs of manufacture is to drive the consumer away from the book-stores.

The qualities that lead a person to found a business and bring it to maturity and those that make a good manager are quite different—the former calls for innovation, the latter for statesmanship. Such terms as "rugged individualist" and "economic royalist" describe the owners of the preceding century better than they do the managers of the present.

<sup>2</sup> *Publishers' Weekly*, May 19, 1947, p. 2483.

Managerial enterprise is entwined with the national economy. Its acts are important, not only to itself but also to others and often to the community. It has to succeed or it disintegrates, yet its success cannot be at the expense of the community. No codes of behavior or ethics to cover these, at times conflicting, responsibilities have yet been formulated. Political discernment as well as business sagacity is required.

The degree of success that management must produce to remain in office is surprisingly small. Indeed management must fail obviously and even ignominiously before the dispersed forces of criticism become mobilized for action. Directors are slow to act. This is entirely proper for they cannot upset the entire organization for every blunder. Their hope is that things will somehow right themselves. Besides, it is difficult to determine whether a bad situation is due to causes beyond the control of management or to lack of foresight. The balance sheet may yield no immediate evidence whether affairs are improving or deteriorating. Miscalculations may be temporary. Ideas may be premature. The first Chrysler streamlined model in 1934 found no favor with the public. Later it inaugurated a vogue that eventually transformed the pattern of automobile bodies.

This relative immunity to criticism and accountability gave to managers a position they could—and frequently did—abuse. Having become in their own view the paid employees of the stockholders they failed to assume the responsibilities of their position which was that of a trustee. Indeed, so independent did management frequently become that in many cases it felt justified in withholding vital information from stockholders, though they were the legal

owners. There was real ground for this attitude, for the divulging of certain information might be dangerous competitively.

Stimulated partly by the Securities and Exchange Commission and the New York Stock Exchange, and partly spurred from within, managements have drastically altered their policies with respect to secrecy in recent years. For their own protection, they have sought the sympathetic understanding of their stockholders and the public at large. Publicity campaigns have been carried on and annual reports have become veritable fountains of information. The example set by the pioneers in this movement has been followed by many companies which at times seem to vie with one another to see which can tell the most.

This evolution has an unfortunate effect. It puts a damper on imagination and initiative, and makes for an atmosphere not conducive to the taking of risks. Any decision may turn out to have been wrong, and honest mistakes may be twisted into dishonesty by the unscrupulous in litigation. The temptation to yield to timidity is strong. This is the more so because managers know that they are dragging their directors into the shadowy area of interpretation of intent. Management is curiously lonely in its equivocal surroundings. Its relations with stockholders are as unclear as with directors and employees. Directors are its advisers only within limits. At annual meetings they become its critics. Management is estranged from stockholders by the devices of ownership, such as the dummy company. On the surface antagonism rather than mutuality of interest with employees is emphasized by the growth of trade unions, the closed shop, and collective bargaining.

**EMPLOYEE**

Some employer-employee relations under free enterprise in the nineteenth century were very good. Others were very bad. The friendliness of the brothers Cheeryble, whose paternal care of employees Dickens recounts in *Nicholas Nickleby*, and the ugliness of the sweatshop were products of the same economy. Under free enterprise, employers paid wages literally out of their own pockets, personally supervised the work, and had a good eye for quality. When the value of the labor that went into a product could be measured a standard for wage rates was set. The employer either paid this rate or ran the risk of losing his employee to a competitor. This standard could be applied to jobs whose labor output was less easily computed, but required a similar grade of intelligence.

As business grew more complex in the transition stage between free and managerial enterprise, these measurements of individual output became less possible. When employers held the whip hand, they could regulate conditions of work and wages to a considerable extent according to their own ability and inclination. Since the individual employee was less necessary to his employer than his job was to him, the employer had the advantage. The temptation was strong to keep wages at a minimum. Also, so far as employers could move their plant and machinery from one locality to another, they could, when pressed, seek a more favorable labor market. Personal relations, however, mitigated some of the harshness of this impersonal market. Goodhearted employers were not uncommon. As long as it was their own money

they were dealing out, they could allow themselves the luxury of helping faithful employees in need, looking after them when they were sick, and giving Christmas bonuses after a good year.

As managerial replaced free enterprise, there was less opportunity for personal contact. Employees, especially in the heavy industries, were helpless in their efforts to get better conditions. They did not have the bargaining power necessary to protect their positions. During the last decades of the nineteenth century immigrants were pouring into the United States. To survive, they had to accept work upon such terms and conditions as were offered. Here and there trade unions were formed to give employees some modicum of bargaining power. But they were few and far between and for the most part ineffective. Economic theories, the law, and court decisions stood in their way. Out of this situation grew the claim, fiercely propagated by labor leaders and liberals, that labor was not a commodity to be bought and sold on a purely commercial basis. This claim made headway, for conditions were too distressing to be tolerated in a country with expanding production. It is today declared and accepted statutory policy.

While family concerns were being amalgamated into great systems from 1890 to 1910, the free enterprise attitude toward labor continued, giving the employer an even greater bargaining leverage. The first generation of managers, regarding themselves as representatives of their stockholders, thought of wages as coming out of dividends. Generally their concentration on the mechanics of production and the brilliant results which they achieved made them oblivious to their responsibility to the employees.

They had little fellow-feeling for the stream of foreigners who arrived yearly and who could be hired upon any terms they chose to dictate. Even those who were kindly disposed believed they had no right to waste their stockholders' money on wages that were higher than they had to pay. Competition among employers for labor, though stimulated by the westward movement of the population, was insufficient to offset their dominant position. "Business was business." Management justified its low wages by pointing to the impersonality of competition. Occasional strikes were effectively quashed. These and other factors dissipated employee loyalty, a natural concomitant of connection with any institution.

The second generation of managers long clung to the notion that they were primarily responsible to the stockholders. Brought up under free enterprise, they could not immediately modify their viewpoint with the changing conditions of industry. They could hide behind the legal concept of the fictional corporate person and thus rationalize acts for which as individuals they would not have accepted responsibility. Though they were shaping market conditions to a considerable degree, they still thought in terms of free enterprise, under which the entrepreneur had to adjust himself to market conditions. They exaggerated the indefinable risks of competition, and were unwilling to admit that they had moral and social responsibilities to their employees as well as business obligations. The relations between management and employees were at a low ebb during this transition period.

As the position of the individual employee became more and more helpless, the movement toward trade unionism

accelerated. Bold leaders mobilized the forces of labor in order to match the strong bargaining position of management with an equally effective position of their own. Such stratagems as the strike and the picket line, resulting in a collective bargain, were a necessary part of large scale industry under a free enterprise philosophy.

National unions covering an industry began to be organized at this time. Some states passed laws establishing minimum working conditions and minimum wages and hours, especially for women and children, which in retrospect, seem incredibly low. Occasional investigations by social workers and legislatures revealed the poor living conditions of employees. The conscience of the community was so touched that it approved the promulgation of doctrines that gave to the workers some kind of a chance. Despite bitter opposition by management, the right to organize and to strike, the picket line, and collective bargaining, all gained ground. The present-day effects of these practices are infinitely more widespread than they were in those earlier days.

With a few notable exceptions, employees came to look to their labor leaders rather than to management for the amelioration of conditions. Meanwhile, the growth of production opened up opportunities for a higher living standard. Labor unions capitalized on the liberty afforded by free enterprise. The American Federation of Labor guided by Samuel Gompers accepted the philosophy of free enterprise and concentrated upon getting a larger share of the product for workers. But its power was limited in scope. It achieved a modicum of success, but its field was confined to some of the more highly skilled occupations.

With World War I, a new era began. The urgency of increased production brought to light the weaknesses which past labor policies had fostered. Obviously some kind of a change was called for. Management grudgingly acknowledged this need and sought to meet it by resuscitating personal contacts. Labor leaders were given high positions and great responsibility in government. The National War Labor Board, created in 1918 under the joint chairmanship of ex-President William Howard Taft and Frank P. Walsh, consisted of five representatives of employers and five representatives of labor. The objective was to stipulate fair standards rather than leave matters to the impersonal workings of the market. With the consent of the parties disputes were settled and wage rates were set by order of the Board. Again by mutual consent the right to strike was temporarily suspended. Labor relations counsellors, employed by management to correct injustices, obtained a precarious toe hold. Here and there welfare measures were introduced and working conditions were improved. During this period, wages were raised by competition for workers. Heavy labor was at a premium. Health hazards received attention. Employers gave dances and picnics for their employees.

But it was too little and too late. The lines had been formed. Loyalty to unions had paid as loyalty to management had not. At the end of the war, emergency regulations and controls were discarded, and unions made the most of the newly found strength of labor solidarity. They asserted their rights with increased confidence. The belief spread that the constant prodding of union leaders had compelled management to grant higher wages and better working conditions than it would have offered without this pressure.

During the 1920's the number of union members fell off from the level attained during the war, but remained well above the prewar levels. Managements, fearful of a resumption of growth of unionism, were granting wage increases in line with increasing production, so that, toward the last years of the decade, wages and conditions of employment were probably at the highest level ever known. With the depression, came decreases in wage rates, rising unemployment and a further considerable drop in union membership. But after 1933, the position of the unions had a sharp upturn. Section 7(a) of the National Recovery Act of 1933 assured to employees the right to organize and bargain collectively without interference from employers, and restricted the right of employers to control union activities. This increased the stature which labor had already achieved in 1932 through the anti-injunction provisions of the Norris-LaGuardia Act.

The speed with which the unions gained members and power brought about a novel situation. Not only did union membership within old industries rise more rapidly than at any preceding time, but new industries began to be organized. The Congress of Industrial Organizations was formed in 1935. Government actively promoted unionization and collective bargaining as an end in itself. The privileges accorded to unions by the former Section 7(a) were expanded and codified in the National Labor Relations Act, passed in 1935. As the closed shop and check off were included in an increasing number of labor agreements, the unions attained a higher degree of power and of permanence. In this fashion all employees in a given industry could be compelled to join the union and the income of the union was

stabilized. Collective bargaining, which had been inaugurated under free enterprise to give employees some degree of equality, now placed them in many respects in a superior trading position in relation to management. As in a conflict neither management nor unions had any choice except to come to some compromise, the word "bargaining" in the phrase "collective bargaining" lost something of its meaning. The process was accentuated by the formation of the War Labor Board under the chairmanship of William H. Davis. The question of union status was disposed of by maintenance of membership, and the Board devoted itself to settling disputes about wages, hours, and conditions. The most recent striking of balances between these opposed forces in our economy has come with the passage of the Taft-Hartley Act. Here the consequences are daily news and their evolution must await the passage of time.

In effect, the union leader became the employment manager for the industry. Frequently, he passed on terms and tenure of employment, on personnel, on disputed interpretations of rules, on promotions. Though clothed with these vital powers, he stood apart from management and did not share its responsibilities. Yet good wages and working conditions were dependent upon successful and continuous operation. No more could be distributed than was produced. The ability of business to adjust itself to the falling trends of the depression years was limited. The gains labor could win by further fighting were approaching the point of diminishing returns. Improvement once more became linked to increased production as well as to bargaining power.

Under the Congress of Industrial Organizations, entire

industries were unionized. Whereas a generation ago strikes had been local and had had small effect, now they frequently closed entire industries and had profound repercussions throughout the national economy. When the coal mines were shut down, transportation and many manufacturing industries were demoralized. A strike did not even have to be in a key industry. Stoppages in subsidiary industries disorganized the major industries they supplied. The carefully built interrelations could be shattered at many points. The same reasoning that justified the right to strike in free enterprise loses its validity when applied to managerial enterprise. The right to strike is denied to government employees on much the same grounds. As long as unions were a minority power within the industry, warfare might achieve constructive results. But when the minority power had grown to be the major power, the battle had been won. Continued warfare ceased to make sense. A fundamental change in relationship had taken place.

Under a free-enterprise economy, the right to strike was the chief weapon in achieving higher wages and better conditions of work. But under managerial enterprise it may be turned into a fearfully destructive instrument in bargaining technique. Free enterprise is based on competition; managerial enterprise on cooperation. Schooled as labor leaders and managers are in the philosophy of bargaining under free enterprise, both find the shift to co-responsibility hard to comprehend and each is loath to admit its inevitability. So rapid have these changes been that the new relationships have scarcely had time to take shape. Only recently has managerial enterprise begun to recognize the employee as

an essential part of the production mechanism. The obligation of industry to furnish steady jobs has been conceded by many groups in management and stressed by the Committee for Economic Development.

Several trends are in process of formation:

(1) *To pay all workers of the same grade and seniority in an industry at the same rate.* Uniformity of wages and conditions expresses an historic union attitude. It disassociates employment from the state of business and tends to work a hardship on the company unable to meet the standard set. Obviously, such a mechanical rule in part disregards the qualities that make an employee extra valuable.

(2) *To give employees a share in profits.* This doctrine is in direct contrast to equal pay for equal work. Here the assumption is that a company should pay wages in accordance with its ability. Consequently, more successful companies should pay higher rates of wages than less successful. As wages are dependent on a company's ability to survive, it must be permitted to make profits. The employee becomes a participant in earnings and has a stake in the business. The application of this philosophy is of necessity vague, though attempts have been made to formulate in advance the proper division of earnings above a stipulated minimum. This emphasis on partnership between employer and employee has been particularly strong in the clothing trades. Under the leadership of Sidney Hillman the Amalgamated Clothing Workers Union has, on occasion, made loans to employers to tide them over a business slump and to maintain employment.

(3) *To give steady employment at a guaranteed annual*

*wage.* As John Maurice Clark has brilliantly argued, in *Economics of Overhead Costs*, wages are as regular an expense as any other expense. Similarly grocery bills and rent must be paid by workers in bad times as well as good, in slack and busy seasons. The theory is that after a certain time, the job comes to constitute a vested interest which should be recognized by assuring continuous employment. The Proctor and Gamble Company has demonstrated the practicability of the annual wage for certain types of industry. It must be remembered, however, that demand for soap is more constant than that for many other products. The regular force, defined as employees who have worked for the company two years, are guaranteed forty-eight weeks of work and about 80 per cent of the employees of the company are included under this arrangement. The custom of giving separation pay similarly rests on the theory of an acquired vested interest in the job. In case of dismissal, the loss of this vested interest must be compensated for.

(4) *To have a welfare fund administered by the union in the interest of the employees.* Many companies have already instituted a welfare fund. Some manage it themselves while others put it in the hands of a selected group of employees. The amount is usually determined by the management and is dependent upon the profits of the preceding year. The unions hold such a scheme to be inadequate. They demand that a fixed royalty or percentage of payroll be set aside and administered by them. This demand has received a setback in the Taft-Hartley Act,<sup>3</sup> which provides that welfare funds be administered as a trust fund for specified ob-

<sup>3</sup> Labor Management Relations Act, 1947; 80th Cong., 1st Sess., HR 3020, Sec. 302, C-5-B.

jects jointly by an equal number of representatives of employers and employees, together with neutral representatives as are agreed upon or appointed by a designated court.

(5) *To recognize labor's right to participate in management, either on the board of directors or in the management group.* This controversial demand is resisted by certain groups among both employees and management. Labor fears the appointees will lose their identity as representatives of labor and will inevitably be drawn into the complex problems connected with the survival and success of the business. Management fears that the presence of a representative of labor would lead to internal conflicts that would endanger the business as a whole. They agree that the divided loyalties of a labor leader on the board of directors would have unpredictable potentialities. To make his voice count, he would have to cease to be an advocate for the particularized interest, and to visualize it as a thread in the entire fabric of the economy.

None of these tendencies has progressed beyond the experimental stage. New relationships are being forged in many industries. Yet all have one thing in common. They are based on the recognition that employees are an integral part of the business. Employees are no longer considered mere hired hands, as they were under free enterprise. Taken together with the evolution of management toward becoming the arbiters of the whole business in contrast to their former role as the representative of the stockholders, these tendencies are crystallizing into a new concept of the position, rights, and responsibilities of employees.

*P A R T* *T W O*

## THE METHODS

C H A P T E R

4

### The Problems of Management

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IN THE OPERATION of managerial enterprise the gulf between its methods and those of free enterprise becomes evident. The success of managerial enterprise depends upon a neat and continuous synchronizing of its diverse elements—from the steady flow of the raw material to the men and machines that create the products through to the maintenance of customer demand. In addition to these elements the essential operations are—keeping records, conforming to the legal structure, financing, studying technical im-

provements, adjusting to the changing requirements of industry and the public, winning and keeping a reputation, strengthening trade advantages and position in the industry, formulating price policies and negotiating with the government.

Every organization is susceptible to deterioration. A business loses customers through death, change of domicile, the lures of competitors. It loses trained personnel for the same reasons. Its physical equipment is continuously depreciating or becoming obsolete. Its products go out of style or vogue. Its location may become less convenient. Management can never rest. It must rebuild at a rate equaling or exceeding the deterioration.

Managements act in terms of self-created budgets, standards or quotas, which are called "bogies." They estimate what their share of the total output of the industry should be, or consider that advertising is at the right pitch when it bears a certain ratio to selling costs. Each industry and concern has its own bogies. Together, they constitute the standards of performance the industry must strive for. When they are realized, business is good, and when they are exceeded, it is very good, but when they fall short, business is bad.

Bogies are watched carefully and unremittingly. Departures from them are anxiously analyzed. If they are accidental and temporary, they are ignored but if they indicate a trend, they must be studied. When departures seem unavoidable, the bogies are revised or adjustments are made to correct the trend. A typical bogie of costs in a department store would be about as follows:

	PERCENTAGE OF TOTAL COST
Cost of merchandise	60
Direct selling cost	5
Indirect selling cost	6
General overhead	6
Maintenance and depreciation	4
Advertising and display	6
Rent	4
Markdowns (breakage, damage, errors)	6
Margin for profit	3
	<hr/> <u>100</u>

The various elements of cost are closely interrelated. Advertising is high when rent is low. Markdowns are substantial when the original markup is high. Any variation of cost, however slight, affects the profit margin disproportionately. overshadowing all else is total output, for when it does not come up to the quota on which costs are reckoned, percentages get out of control. Contrariwise, when it exceeds the quota, overhead is decreased and profits are large. Some costs vary with volume, others are fixed. The volume of business done must be sufficient to keep dollar and percentage costs in balance.

When the various elements get out of alignment, management must look for the source of trouble. The selection of merchandise may be faulty or the assortment too large or small, prices too high or too low. Selling skill may be deficient or general maintenance may have been slighted. The border area between success and failure is narrow, especially during depressions. And success depends upon the right relation between percentage and dollar costs.

Management thinks in terms of the relation of each part to the whole and vice versa. For example, if the plan is to increase the output of a factory, regard must be had to the adequacy of the selling force, advertising programs must be reconsidered, attention must be paid to the procurement of raw materials, and so forth. Management estimates how the whole might be affected by a new or greater specific expenditure or alteration of price. In the case of one company failure to think forward and backward almost led to ruin. When in 1930 its volume fell, less capable employees were hired at lower salaries. The result was a less adroit selection of merchandise and a drop in sales. Though variable expenses were temporarily brought into a sound relation with the smaller volume, sales continued to fall off. The disproportion among the fixed expenses became ever more tragic until the total concern was operating in the red. Along such lines there was no possibility of recuperation with better times.

The sole remedy was the bold one of acting according to a set of standards unwarranted by the current volume in the faith that demand would be stimulated. Under a new management, bogies were set on the anticipated future rather than the present. Wages were raised to bring in better personnel, stocks were increased to give a wider selection, advertising was stepped up, prices were lowered. The losses were heavy until a volume adequate to put the store in the black was finally reached. Soundness is a virtue in prosperity but a sin in times of trouble.

The manager of a popular low-priced establishment had just the opposite experience. After an exceptionally good year, he decided that he owed his customers better sur-

roundings. So he installed new fixtures, air-conditioning, lights, and made the store more attractive. To his astonishment, instead of being grateful, his customers thought he had gone high-hat, and must have raised his prices. Not until he had mutilated his fixtures, turned off the air-conditioning, and dimmed the lights did they flock back.

As has been emphasized, a steady and predictable demand is the lifeblood of managerial enterprise. The broader the base of customers, the better. Demand for articles consumed daily by the general public is the most predictable. Proctor and Gamble regulates its output by the amount of its soap used daily, rather than upon the amount sold. Thereby it maintains a continuous flow of production and guarantees steady employment throughout the year.

However, the articles for which demand is steady are not many. For some articles it is seasonal. More toys are sold just before Christmas than during the entire eleven other months. Heavy clothes are sold in winter, electric fans in summer. As the public does not anticipate its wants, an attempt to stimulate sales out of season is often fruitless. Furniture and furs are notable exceptions.

When John Wanamaker found that midwinter and midsummer were seasons of extreme dullness, he staged furniture sales in February and August with special discounts and prices. These proved so successful that others took up the idea and these off-season months became the busiest periods for furniture. Midsummer fur sales too have justified themselves. The saving appears to be so large as to attract customers. But all attempts to spread the sale of toys through the year have proved futile. Most difficult to regularize are the sales of articles having a relatively small group

of customers and a long expectancy of use—ships, railway cars, locomotives, building materials. As the variation in demand for this type of goods is cyclical, not much can be done to regularize it. Any practicable price concessions would not increase the demand, and to manufacture for stock on a large scale is not feasible.

With production waiting on distribution, every seller is at a disadvantage except under conditions of scarcity, caused by some extraordinary circumstance such as war. Scarcity indicates a major break in a smoothly functioning administration, and a reversion to free-enterprise economy. The seller has specific articles for sale. The purchaser has various wants, and many articles compete for his attention. Often a tiny detail tips the scales in favor of one article. The article may have the practical qualities the purchaser desires, but the color, shape, or ornamentation may not be to his taste. Again its trademark may be so unfamiliar to him that he has no confidence in it. Advertising in newspapers or on the radio is only one of many ways to bring goods to the attention of potential purchasers. Window displays, personal salesmanship, articles in magazines, mail-order catalogues, all perform the same function. After demand has been aroused, the article must be readily procurable, and the price must be in line with effective demand.

The actual rate of output follows distribution, but its anticipated volume precedes it. The plant must be designed to a calculated output and the capacities of machines performing the various processes must be geared into one another. Deviations from uniform capacity cause either under-utilization or overcrowding. Both of these are wasteful and expensive.

On occasion extra facilities of production are exceedingly valuable, but they must be carried through average and depressed times. Exactly how much idle capacity a firm can afford to maintain in normal times to take care of seasonal and emergency demands requires a careful balancing of costs. Analogous to this is the problem of carrying excess size in expectation of growth. The ability to expand was a national asset at the outbreak of the war, for it made an immediate increase of output possible. It is a great advantage to the American Bank Note Company to be able to turn out a bond issue on short notice. A shipyard can make extensive repairs quickly if it has idle ways. If hotels are to accommodate late guests or take care of rush seasons some of their rooms will be unoccupied in normal times. The ability of railroad and airplane companies to render last minute services is important, but this also means empty seats when travel is light.

That production may be uninterrupted, the regular sources of supply must be assured. In most cases, this can be done by contract, but ownership may be advantageous. Though the United States Steel Corporation bought into the Mesabi Range in 1903, possession was not of crucial significance for thirty years. Oil companies contract for land they have no thought of tapping in the near future. Their undeveloped acreage is frequently ten times as great as that in which wells are drilled. The Firestone Rubber Company owns plantations in Liberia, and the United States Rubber Company has a large investment in the East Indies. Sugar refining companies own producing properties in Cuba and Puerto Rico. The United Fruit Company owns banana plantations so that it can synchronize cutting with

shipping. Chain grocery stores at times assure the flow and quality of their supply by owning farms and canneries.

The extent of this vertical ownership varies from industry to industry and from time to time. Airplane and automobile companies are largely assemblers of parts bought from specialist manufacturers. The textile industry has until recently been subdivided into spinners, weavers, finishers, and manufacturers. These units are now being integrated so that the flow from the source of the raw material to the ultimate consumer can be controlled more effectively.

In a well-managed concern, finances in general play a negative role. A sound financial condition is the outcome of skillful management. A precarious condition comes about only when calculations go awry. The literature on the technical aspects of finance is voluminous and extended exposition is beyond the scope of this book. Existing facilities render the raising of new money for expansion a routine affair. The regulations of the Securities and Exchange Commission, while cumbersome, offer no insuperable obstacles. Only when money has to be borrowed under stress do the terms become onerous.

The continuity of operation in managerial enterprise has its counterpart in continuity of financing. When operations never stop, loans are seldom made for a specific purpose. Fixed-term obligations, especially of large amounts, may be an embarrassment if they happen to fall due at a date that may be an inauspicious time for paying them off or for refinancing. Loans that can be paid off piecemeal out of income are desirable. Even better are preferred shares of

stock having no due date, yet redeemable at a predesignated price.

Likewise, continuity of operations has diminished the importance of short-term self-liquidating bank loans and commercial paper. The role of loans in industry has been reduced to meeting the cash needs of seasonal variations of demand or production. So small has this requirement become that banks have been forced to look elsewhere for short-term paper to ensure their liquidity.

| Another problem that is both important and ticklish is the cultivation of public relations. Not only must the approval of customers and the confidence of the public be won for the individual company, in addition, the standards of the industry must be kept high. Good will is a generic term for the asset that accrues to companies in the course of time, if they make loyal customers and thereby assure continuity of demand for their product. It is sound practice to try to add good will by every transaction. Large department stores owe no small portion of their success to a policy of always heading the list of contributors to every civic movement—and indeed searching out channels of their own through which to benefit the community.

Notable in this respect are Bamberger's in Newark and Dayton's in Minneapolis. Lord and Taylor in New York has solidified its position as a leader in fashion by giving annual prizes for outstanding contributions to industrial design. The J. N. Adam Company has underwritten performances of grand opera in Buffalo. Hart, Schaffner and Marx for many years offered prizes for economic essays. Pepsi-Cola holds annual competitions with awards for paintings and exhibits those chosen by a jury throughout the country.

Thomas J. Watson of the International Business Machines Company has long made a practice of collecting art, representative of each of the 79 countries in which his company operates, and lending the exhibitions to any museum that requests them. This tie-up between industry and art, he believes, has a salutary effect on business contacts and international relations, creating a genial atmosphere.

Many organizations employ an officer with no duty other than to cultivate good will in its broadest sense. He is a member of charity boards, a leader in civic affairs, arranges dinners for prominent persons or causes. He throws himself into community drives, attends conventions and straightens out petty snarls. Rarely do his efforts yield tangible results, yet their intangible effects are evident in all kinds of ways when negotiations are undertaken. The excess profits tax encouraged this form of institutionalizing. For if the expense could be written off as a cost, it would be borne mainly by government.

Advertising policy is dominated by fear. Hope creeps in just sufficiently to emphasize the dominant role of fear. In essence, advertising is simply an announcement of products for sale, accompanied by a statement of their virtues and prices. Professionalized, it has become a psychological pressure, backed by all the tricks of repetition, analogy, and association that may make a product a national institution. It is the fear of losing their place in the economic structure that spurs organizations to excessive and apparently wasteful expenditures. And they have reason to be afraid. Pear's Soap, Sapolio, Fletcher's Castoria, and Force were all once household standbys. Pinching on advertising might convert a cigarette that is popular today into a beautiful memory.

Viewed as insurance, the expense is a relatively small extravagance. A great firm of manufacturers in converting to war production dared not let the public forget its product. Current profits, assured as they were by war contracts, were not at stake but future profits and indeed the very existence of the business might be at stake. Consequently, the costs of advertising articles unobtainable as long as the war lasted were held to be a proper expense of war production.

On many balance sheets, good will is carried at a large sum. This is justifiable, for good will is difficult and expensive to achieve. Conservative balance sheets write it down to one dollar. Others enter the amount actually paid for it when the business was purchased or at a figure found by a capitalization of earning in some past period. Though the figure itself is an estimate, it has definite reality behind it.

No balance sheet ever carries ill will as a minus item. Yet ill will is just as real as good will, and has just as much influence on the future of a company. It is positively injurious. Almost anyone takes a chance on a new contact, but a burned customer seldom returns. Does one go to a restaurant again if the service has been poor or the meal badly cooked on a previous visit? Certainly not, one tries another restaurant. Similarly, an unfortunate experience in one shop sends the customer and often her friends and acquaintances to other shops. A customer may remember that many years before she came away empty-handed because she found nothing worth buying. The defect may have been corrected long since, but the public has never become aware of the fact. Ill will is a distinct disadvantage, difficult—if not impossible—to overcome.

Perhaps the railroads achieved ill will on the largest scale

of any industry. The phrase attributed to Commodore Vanderbilt—"The public be damned."—crystallized the hostility. Though the popular version that it was used in connection with a refusal to install increased comforts for the traveling public was probably wrong, the phrase stuck. The most likely story runs that one night, after a grueling day of inspection, the Commodore was awakened in his private car and asked to meet reporters. When he demurred, he was told that the public would appreciate a statement. Half asleep, he ejaculated: "Let me sleep—the public be damned." Thereafter, any rudeness by a conductor or ticket agent was taken by the passenger as a gratuitous insult. Many a traveler today approaches a railroad station with a chip on his shoulder.

Some railroads have tried valiantly to counteract this hostility. The standards of solicitude of the Baltimore and Ohio for its passengers' comfort are a model. Many people prefer to travel on this road though the running time between New York City and other stations is slightly longer than that of its competitors. The Chesapeake and Ohio has inaugurated the buying of tickets on credit. Other roads have established "Charm Schools" to teach courtesy to their employees. Although ill will is not an item entered as a liability on railroad balance sheets, it is reflected in the market values of railroad securities.

Air transport companies have utilized expensive expedients to make up for the inconveniences caused by weather. When planes are grounded, train reservations, meals, even hotel rooms are provided, and this expense is cheerfully borne. The most gracious host could not treat his guests with greater consideration. No opening is left for the

growth of ill will and no effort spared to emphasize the routine aspects of air travel. Records of passenger miles flown without accident as compared with other means of travel are widely publicized. If the weather is unfavorable, schedules are revised and planes grounded until it is deemed safe to fly.

The manufacturer dreads the ill will of his customers, mainly merchants, no less than shops and transportation companies. He operates an expensive system of inspection to ensure the maintenance of his standard of quality. Large sums are invested in tests and experiments. Chinaware used to be baked in great kilns which took several days to heat to the required temperature and then several days more to cool to a point where men could enter and remove the articles. The invention of a tunnel through which the ware could pass on a moving platform greatly shortened the period. At the outset, the platform shook so that the molten ware hardened out of shape, and emerged with a high percentage of imperfections. The discredit thus cast upon inexpensive chinaware as a whole made customers shy of buying it long after its quality had been improved.

The disasters that came to rayon in its early stages when it was known as artificial silk almost ruined its market. In an effort to associate it in the public mind with silk, it was dubbed "art." silk; the period after the art being explained as indicating an abbreviation of artificial, not artistic. The subterfuge was successful, but had disastrous results. Mistaken for pure silk, garments were washed in the ordinary way and went to pieces. They blazed into flame when cigarette ashes were dropped on them. The least strain caused runs. Disgusted customers returned articles in great heaps

demanding a refund and vowing they would never again try such a disappointing product. Not until long after the faults had been corrected and rayon came to be recognized as a product in its own right, distinct from silk, was the public's confidence restored.

The difference between first quality, second quality, and rejects is arbitrary and it may have nothing to do with serviceability. But users realize that some standard has been applied in the marking. Any deviation from this standard engenders distrust and ill will. Slips will occur under any system. But they cannot be allowed to occur too often and they must be corrected promptly and cheerfully, even though they are imaginary. If a small concern commits too many it will find itself out of business. Large organizations, making good their expressed and unexpressed guarantees, suffer a never ending series of losses. The disadvantageous position of the seller cannot be overemphasized. The ordinary manufacturer makes a few products or classes of products. His customer, the merchant, deals in a great variety and can switch from one product to another. The final consumer is at liberty to go where he will.

To the merchant the ill will of his customers rings the death knell of his business. He is always on the lookout for any signs of its growth either through gossip or public accusations. Consequently, the effects of charges made by such agencies as the Office of Price Administration or the Department of Justice have a terror far greater than the fines and punishments they might entail. The charge itself is what is feared most. The result in court, even acquittal, is likely to go unnoticed. The merchant may be exonerated, but he cannot help knowing that he has lost the con-

fidence of some of his customers. The repetition of unfavorable comment in private is no less devastating. It either keeps potential customers away or gives rise to a suspicious attitude which hampers the daily transaction of business. When nothing can be ordered on faith all purchases must be inspected and personally selected. Hence elaborate machinery must be set up to correct minor errors. In dollars and cents this costs far more than the errors, but it is worth every penny in preventing ill will.

As an economy becomes more organized, the opportunities for breeding ill will multiply and those for correcting bad impressions lessen. For example, canned goods, candies, perfumes, and even shirts are bought sight unseen. No inspection can disclose the wearing quality of shoes, for the essential features are hidden. If any article such as these falls down in use, there will be no repeat order. The manufacturer has no chance to explain. His carefully guarded reputation may evaporate quickly. Hence more and more minute checks are introduced and personnel and time are lavished upon the correction of errors. These far-flung organizations with their equally far-flung economies are more sensitive to public good will than their critics realize.

The position of an industry as a whole is usually looked after by a trade association, supported by member contributions. Such practices as disparagement of competitors and unwarranted claims come under fire as the ethics of the community rise. Advertising statements that were considered proper a generation ago would not be tolerated today. Then the labeling of packages was so flamboyant as to

call in question the honesty of all concerned. The fear of danger to their reputations caused newspapers and merchants to raise industry standards. Trade associations formed new departments to investigate complaints. Better Business Bureaus were founded. Government reforms instituted by the Federal Trade Commission and the Bureau of Standards were welcomed. And individual concerns went to great lengths to tone down the exaggerated claims that threatened the reputation of their industry.

It was the disregard for the growing disapproval of its standards that subjected the Stock Exchange to the control of the Securities and Exchange Commission and later led to its own internal reform. By way of contrast the banking system, supported by individual banks, is always on the watch for the general effect of accepted practices. Local, state, and federal banking associations exact a heavy toll in dues and work from their member banks. The exertion, time, and thought demanded of higher executives may be more burdensome than the contributions. Chambers of Commerce do not confine themselves to any one industry. They concern themselves with business as a whole. Business associations are formed for specific purposes—to lobby for a change in tariffs, to prevent thefts or accidents, to lower taxes, to engage in research, and a host of other undertakings.

Raymond Moley in an illuminating study of the motion picture industry shows how sheer necessity has brought about cooperative practices. Reports of the immorality of actors and actresses had made the entire film industry suspect and many pictures were banned as obscene. Public antagonism was mounting. Pricked by Will Hays, this un-

willing industry was compelled to curb itself, to adopt trade rules and standards, and to apply them more and more strictly. Thus self-regulation enforced by leaders in the film industry saved it from government control, censorship, or disaster.

While railroad rates are subject to the approval of the Interstate Commerce Commission, the methods of arriving at rates are those of managerial enterprise in administering prices. Rates have long been fixed in conferences, participated in by both carriers and shippers. Though railroads are subject to one branch of government supervision, another branch, the Department of Justice, now attacks this method as not conforming to the principles of free competition. The railroads contend that it is the only possible method by which a workable pattern of rates could be obtained, and that government supervision safeguards the public interest. Regarding this practice, Joseph B. Eastman stated:<sup>1</sup>

It must be evident to any reasonable man that the carriers cannot respond to all the duties imposed by law, if each individual carrier acts in a vacuum. It is a situation, under all the conditions, which plainly calls for consultation, conference, organization and for many acts of a joint or cooperative character.

Joseph Pogue, who has made a life study of the oil industry, emphasizes similarly the coordination of production processes:<sup>2</sup>

<sup>1</sup> Testimony before the Senate Committee on Interstate Commerce, June 15, 1943.

<sup>2</sup> Excerpt from a speech made before the Engineering and Human Affairs Group, Princeton University Bi-Centennial, Oct. 2, 1946, "The Development of Natural Resources—The Contribution of the Petroleum Industry to Resource Administration."

In the realm of efficient extraction of petroleum from the ground, the petroleum industry has achieved notable progress. This has been accomplished with the aid of state conservation laws, since the small lease-holds prevailing in the United States necessitate off-set drilling and hasty withdrawals of the oil if not countered by a restraining influence. In the early period of the industry's development the significance of the rate of production per well was not understood, but in the last two decades the wide-open flow of oil wells has been found to be inefficient and has been replaced by a system of proration under the supervision of the states, but with the full cooperation of the industry, whereby oil wells are held to or below the rates of flow which permit the optimum utilization of the reservoir energy. Thus practical conservation has been achieved together with some measure of stabilization of the industry, without unduly impairing the freedom of individual action so necessary for multiple effort.

The growth of regulation is in each of these cases due to the chaos that ensues when a managerial enterprise is forced into the competitive methods of free enterprise. The efforts to stabilize conditions are not restricted to price-fixing. For example, in the film industry, the types of picture, the scenes, and the dialogue are all supervised to avoid offense to any significant group. In the machine-tool industry, the sizes of bolts and nuts are standardized. In the garment industry, women's dresses are manufactured to sell within certain price ranges. In the glass industry, patents are pooled and controlled.

Another major problem is posed by the industry's rela-

tion with government. This absorbs a large portion of the attention of management. With few exceptions, these relations have not been cordial. Management has been on the defensive, to justify its actions and methods to meet the criticism of some branch of the government. This is particularly true of the relations of management and government in peacetime. Under the stress of war and patriotic appeal, government and industry go into partnership to increase the production of military necessities.

In collectivist industries, and in some that might be classified as managerial, government regulative bodies in applying their rules tend to become administrative. This is illustrated by the refusal of the Interstate Commerce Commission to permit a change in the traffic rate on salt between two points on the ground that its production in other localities would be adversely affected. In like manner, the Federal Communications Commission determines many details of radio programs. So likewise the Civil Aeronautics Board fixes mail rates in accordance with its judgment as to the requirements of the routes and earnings of air lines.

Trade associations are the point of contact between management and government. The representative in Washington has a place of vantage from which to follow the daily actions of Congress and the decisions of these regulatory Commissions. Lawyers, many of them former officeholders, set themselves up in Washington to act as guides to industry in need of help. They know their way around. The best representatives are of course the heads of concerns, but they are busy with their own affairs. Unversed in the give and take of politics, however, they are inarticulate when called upon in argument.

Few concerns have had their interests as vigorously presented as were those of the Commonwealth and Southern Corporation by its lawyer-president, the late Wendell L. Willkie. The combination of a trained debater and an able corporate president is rare indeed. Too often managements do not foresee the social results of what they do or fail to do. They oppose blindly any change that may be proposed and do not offer a constructive alternative.

Not all relations of industry with government, however, have been unhappy. Now and then there have been instances of genuine cooperation. The great housing development in lower Manhattan would have been impossible without the closest cooperation between the city government and the insurance companies that made the investment. The reports and statistics of the Department of Commerce, the Federal Reserve Banks, and of the Census Bureau play a vital part in the decisions of management. The activities of the Securities and Exchange Commission and the Federal Trade Commission often raise the standards of ethics under which industry operates. Occasional spokesmen for industry in Congress blunt the sharpest edges of unfriendly legislation. The Secretary of Commerce may act in line with the views of his business advisory committee.

Still another fascinating problem arises in connection with research. In developing industries, new raw materials, new alloys, new combinations, new techniques, and shifts in demand follow one another relentlessly. Fortunately, they are usually so minor that each can be adjusted to as it occurs. In an article written for the Thirty-fifth Anniversary of Lybrand, Ross Brothers and Montgomery, Frank B. Jew-

ett described the situation in this regard that existed in 1933:<sup>8</sup>

In industry the entire scope and character of the science machine is altered. . . . Now, because the power of scientific research is primarily in the trained brains of men and the methods they employ rather than in their fund of accumulated special knowledge, no industry based on science is free of danger from the most unexpected quarter. Any industry possessed of an efficient research organization can direct its attack against almost any objective. An efficient industrial research organization does not necessarily mean a great aggregation of individuals or a huge annual outlay of money. What it does mean is a picked group of competent men thoroughly trained to handle the tools of science and organized into an efficient team closely coordinated with all the other functions of the industry.

In order to anticipate changes and make adjustments in an orderly fashion, many concerns have organized research laboratories with the sole object of keeping abreast of progress. This fear of falling behind in the procession often puts a concern in the lead as new devices are patented. Estimates indicate that the cost of industrial research is in the neighborhood of a half billion dollars annually. The result is that few inventions nowadays can be attributed to an individual. Most of them are due to the collaboration of groups.

Wise managements do all they can to foresee the effects of technical changes, especially in the chemical, plastic, and

<sup>8</sup> Lybrand, Ross Bros. & Montgomery, 35th Anniversary Pamphlet, 1933.

related industries, and thus to take advantage of innovations and guide them along constructive lines. They attempt to utilize old equipment to its utmost, gradually replacing it by new, so as to avoid sudden capital loss. An outstanding example of this was the skillful introduction of the so-called French telephone. The old instruments were gradually shifted to outlying districts rather than discarded so that their value was in part conserved.

Thus the function of management is to keep all its operations in equilibrium. Both growth and deterioration destroy equilibrium. Its restoration is a continuous process. Relying upon its experience and its penetrating vision, management arranges and revises policies so that it can survive in the present and face the future with a favorable trade position. Frequently, one policy must be sacrificed for the sake of others. In reconciling conflicting policies, management is more concerned with its future trade position than its present. For today is tomorrow's yesterday.

## CHAPTER

# 5

## Maneuvering for Trade Position

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**MANAGEMENT ADOPTS** every strategy to gain a superior position that will facilitate its operations in the future. Such a superior position is made up of many features collectively described as trade advantages. Thus a high regard by both its customers and the general public is essential to every going concern. Of course the qualities for which enterprises wish to be known vary widely. One concern stresses its reliability or service, another its low prices, this one its wide selection, that one exclusiveness, and still another the style of its products. One newspaper will become distinguished for its wide coverage of news, another for its special features.

The first step in gaining a trade advantage is to create a taste for a particular brand of soft drinks, cigarettes or beer, or inculcate a desire for better cars, the newest household gadgets or the latest Paris or Hollywood clothes. The second is to satisfy the demand that has been created.

Each concern strives to become known for some quality or specialty, so that it will be sought out by users and more

important still, by potential users as the best source of supply for their needs. It may concentrate on a single product—Wrigley's chewing gum, Hershey's chocolate, Master Mixer, for example. Or it may expand to cover a variety of products, as Fleischmann's did when it added liquor to yeast. Or again it may cover a wide range. Thus General Electric stamps with its mark all manner of electric machines from the largest to the smallest and from those for industrial to those for household uses.

The indispensability of reputation is most evident when it is lacking. All transactions become difficult and cumbersome. Every new product starts from scratch. Experience indicates that to launch a new article into the stream of commerce takes twice as long and costs twice as much as the most conservative estimate, with its ample allowance for delays and miscalculations. Quality must be proven, performances demonstrated and guarantees given. Moreover, most new products, no matter how rigorously tested in the laboratory, are likely to show defects when subjected to use. Even after the product has been perfected, persuading the public that the defects have been corrected is a long, hard job. The early automobiles furnished more humor than transportation. Many a housewife who bought a mechanical refrigerator when it first appeared on the market wished she had kept her old icebox. Many articles never pull through the trial period and quietly vanish from the scene.

The immediate and widespread approval of nylon is an interesting exception. It was due to a series of fortunate circumstances seldom present in the introduction of a new product. These were the sudden curtailment of raw silk during World War II, the high degree to which nylon had been

perfected before it was put on the market, the general reputation of the Du Pont Company, an ingenious publicity campaign, consumer dissatisfaction with cotton and rayon hosiery, and a marketing system ready to hand. With these advantages, nylon became established almost overnight.

Then there is location. Its advantages vary considerably as for instance between a factory and a retail store. For a factory, except when location has some peculiar natural advantage such as water power on a stream, several sites may be equally good. The natural site is near the sources of raw material or the market for the product. Availability of labor draws many factories to thickly populated areas. These advantages shift from time to time, making it possible for a factory at one site to produce more cheaply than another less fortunately situated. Location is a real, though not often a crucial, trade advantage for factories.

Real-estate agents classify retail sites as 100 per cent, 60 per cent, and local. It is said that the best site is where the best business is. Few businesses are so outstanding as to transform an off into a central location. Retail rents vary greatly. An off location has a per foot rental of one-third to one-half that of a prime location, depending upon the density of traffic. A prime location is more important for a store serving the general public than for one with a class clientele. A variety chain store handling articles of general use has no distinctive character and must depend upon convenience to draw its customers. Sears, Roebuck is an exception. Locations on the outskirts of the marketing area are deliberately selected for low rents. Then reliance is had upon service, parking space, and the pulling power of its large assortments to persuade customers to go off the beaten

track. A furniture store in Camden, New Jersey, has such a reputation for range of selection and excellence that it attracts a large trade from Philadelphia across the river. Such cases however are unusual. For retailers the location that contributes even a slightly greater measure of convenience is of decided advantage. So much for location.

A manufacturer must make arrangements for a considerable period to ensure the flow of raw materials or goods in semifinished stages. Contractual relations are also involved in leases on property, a stable labor force, the distribution of products, and the like. Contracts for the delivery of a stated quantity of materials each week or as desired assures a steady supply. Long-term contracts with a distributor have the advantage to the manufacturer of enabling him to schedule his production program and to buy ahead.

Similar are contracts giving a dealer in an area exclusive right to handle some particularly desirable product. The advantage to the manufacturer is that he is assured of extra zeal in the sale of his product; to the dealer, that he has a specialty to offer. When the contract calls for a fixed price, the manufacturer runs the risk that the price of either materials or labor may rise. If a sliding scale of prices is agreed on he is safeguarded against loss. Some goods are manufactured on a cost-plus basis, but this type of contract is usually not conducive to efficiency.

Both manufacturer and distributor are interested to see that long-term contracts are profitable to the other. The real conflict of interest takes place over the ownership of the trade-mark under which the article is sold. This is for the reason that the name increases in value with each sale, and on renewal dates the owner of the trade-mark is in the

better bargaining position. If it is the manufacturer, he can the more easily turn to another distributor. So likewise if it is the distributor, he can the more easily find another manufacturer.

Ownership of resources may be a vital factor of security. It confers a unique ability to produce quickly and in large quantities when other sources of supply are for any reason shut off. Possessing its own iron ore in the Mesabi Range has proven a boon to the United States Steel Corporation. The Aluminum Company of America has a powerful position through its ownership of bauxite fields and water sites. Similarly placed are the International Nickel Company through its control of over 90 per cent of the world nickel reserves and the Climax Molybdenum Company through its mines in Colorado.

In some industries one company has succeeded in assembling such an overwhelming concentration of machinery, in both quality and quantity, as to be pre-eminent. That has been the objective for which it has striven. The American Bank Note Company has attained this enviable position through its ability to turn out quickly large quantities of bonds, stock certificates and paper money. The Minneapolis Honeywell Company has also achieved this through being able to manufacture delicate instruments that register changes of heat and cold under a great variety of circumstances.

Trade connections contribute materially to a trade position. Built up over many years of profitable and pleasant dealings, personal contacts oil the wheels of commerce. Orders can be placed over the telephone with confidence that the quality of the goods will be up to standard, the price

right, and delivery punctual. Steady customers do not have to be overapprehensive about shortages. They know that the manufacturer to whom they have stuck in a buyer's market will help them out by diverting shipments to them when goods are hard to get. Business relations with a background of many years' standing and good will lead to mutual cooperation between manufacturer and distributor. Selling at accustomed terms and discounts rather than pressing an advantage pays off when the pinch comes.

One of the chief handicaps with which a new business starts is a lack of such trade connections. Until it can turn occasional into regular customers, it must work for each sale. Potential customers must be sought out and persuaded. They want to be shown. Costs are high because the new business must either buy from hand to mouth or invest in a large inventory which it will have to get rid of at a loss if prices decline. When demand declines, customers favor old friends. Money is harder to borrow when credit is not firmly established. No matter how lavish the assistance offered by government, new business is confronted with this disadvantage.

Important is know-how. The organization of an enterprise is merely the first step. The ability to use it efficiently comes next and is just as significant. The old saying that there are tricks to every trade acquires an additive meaning with mass production and distribution. Small savings and minute improvements are multiplied in their effect. Waste products can be utilized if they amount to enough in the aggregate to justify setting up a system that will garner and convert them. Large packers can process and profit on by-products more effectively than small packers. Large distrib-

utors can either sell or re-utilize the wood and paper containers of incoming merchandise. Carbon black is made from gas that had previously been dissipated in the air. The motions in a production line are tuned to the last pitch.

The expert in each operation is several times more efficient than the jack-of-all-trades. But like most prima donnas he is often impervious to the effect of his acts outside his jurisdiction and sacrifices the organization with a blithe disregard. Unless deftly kept in line by an equally expert management, he goes off on tangents that lead to disorder. When, however, such talent as his can be channeled toward productive efficiency, a mature organization is the despair of its rivals.

Closely related to know-how is the research department, producing a stream of suggestions for improved techniques, as well as for new materials and combinations of materials. Without this solvent, know-how stagnates and the progressive system of yesterday becomes obsolete.

A rounded-out system of distribution, services and repairs is a decided trade advantage. Ease of replacement and repair is a major factor in deciding whether to buy one machine rather than another. An excellent system of distribution, such as has been sought by the film industry or by many manufacturers, among them Gulf Oil, Firestone, and Goodyear, puts the firm in a position to fill orders so that the demand of regular customers will not die for lack of sustenance. Distribution need not necessarily be through owned outlets. Any system whereby an article is widely carried and displayed is effective. This may be accomplished by giving dealers special advertising allowances, discounts for quantity or other inducements to push sales.

Manufacturers make every effort to keep the shelves of their distributors well-stocked, often protecting them from loss if sales do not come up to expectations and goods become shopworn. The Eastman Kodak Company makes arrangements so that users of films are put to a minimum of trouble in having them developed. For mechanical articles, a system of repair installations may be organized to ensure the kind of rapid service offered by certain automobile, harvesting, and electric refrigerator companies. The company that has a local dealer on the spot ready to service spare parts has a great advantage over the one whose customers must order from the factory and then wait for delivery. Supplying spare parts and accessories is a considerable portion of many businesses. In airplanes it is estimated to constitute a fourth or a fifth of the total. In safety razors, the continuous sale of blades is more important than the occasional sale of the holder.

The original purpose of the patent law was to promote the progress of science and the useful arts by granting exclusive rights to inventors. From this simple beginning patents have been built into intricate systems involving pools, networks, cross-licensing, and exchanges, which have conferred powers transcending the original concept of the law. The owner of the patented machine may specify in the license agreement the type of patented article that may be produced and the area within which it may be sold. The license may attempt to control the unpatented accessories such as ink, wire, or thread, that must be used in conjunction with the patented article. These attempts to extend

control have had a long and varied legal history. In some instances the courts have validated and in others they have denied the right to insert such terms broadening the scope of the power possessed by the owner. The monograph of the Temporary National Economic Committee entitled, *Patents and Free Enterprise*, states:<sup>1</sup>

The corporation "has, over the years, elaborated a simple permission into a mighty code of perquisites and immunities, clever in their conception, subtle in their justification, effective in their operation. As elements of an elaborate design, they are easy to comprehend; as an organic whole, they present a corpus of authority as formidable as it is bewildering."

The courts vacillate between the doctrine that the owner is completely free to exploit his patent by any means at his command and the doctrine that the public benefit is paramount. With each court decision between these extremes the legal pattern traces a fluctuating course, and the trend is not always clear.

In the glass industry the patents owned by the dominant companies were pooled in the Hartford Empire Company.<sup>1a</sup> Formed to control and license the use of the patents, this company granted licenses with conditions and restrictions intended to maintain the orderly production and marketing of glassware. Unless an enterprise were granted the privilege of using this pool of patents, it was, for all practical purposes, excluded from the trade. It could manufac-

<sup>1</sup> Cf. Temporary National Economic Committee Monograph 31, 76th Cong., 3d Sess., 1941, *Patents and Free Enterprise*, p. 71.

<sup>1a</sup> *Hartford-Empire Co. et al vs. U.S.*; Jan. 8, 1945, 323 U.S. Reports, p. 386.

ture only the articles the Hartford Empire saw fit to permit and for these it paid royalty to Hartford. Thus does the ownership of a patent constitute what we call a trade advantage during the seventeen years for which it is granted.

No less controlling are the intricate pools, exchanges, cross-licenses, and networks in the electrical, oil, and especially the chemical industry, which in one way or another is coming to embrace many other industries such as oil, rubber, steel, and certain nonferrous metals. Such arrangements constitute a trade advantage that cannot be duplicated, and they may approach a monopoly.

The monograph cited above sums up the status of the patent:<sup>2</sup>

A dichotomy, which represents no one's conscious intent, marks the nature of the patent. At law, as statute and Constitution attest, it is a letter which certifies invention and rewards the inventor. In fact, as the stories just recited indicate, it has become an asset to business, a fence about the corporate estate, a weapon of competitive strategy for private industrial government. Its character has been transformed as it has come into a strategic office in the national economy.

Trade-marks are an advantage that may also approach monopoly—at least for a period. When associated with a habit or an acquired taste, they give rise to repeat orders. Symbols and catchwords are hammered home through repetition with a view to impregnating the public mind with belief in the matchless quality of the product.

When a concern is sufficiently dominant in its field, it can

<sup>2</sup> *Idem.*, p. 123.

often utilize its position to exclude newcomers, or to ruin them if they appear to be growing too strong. The mere threat of a trade war, of slashing prices below cost, may be enough. Producers may be persuaded not to supply a new concern with raw material or other necessities. In its early days, the National Cash Register Company kept a morgue of bankrupt competitors. An exhibit of their machines gave pause to anyone considering the advisability of entering the field. Surviving competitors were thus influenced to no small degree in accepting an offer by the company to buy them out. Less drastic, but equally effective in warding off competitors, was the method Judge Hand found was used by the Aluminum Company of America. In his view each newcomer was faced \*

with new capacity already geared into a great organization, having the advantage of experience, trade connections and the elite of personnel.

It is obvious that some trade advantages accrue in the normal course of business while others must be won. All must be tended solicitously. Management attempts to improve its trade position in every way it can. Positively, it follows any lead that promises to strengthen the internal or external structure of the organization; while negatively, it tries to guard against mischance. The more imaginative it is, the more devices it thinks up to secure its future. Every going concern possesses enough advantages to ensure the business of the morrow.

Almost all trade advantages can be duplicated if one has the necessary time, money, and ingenuity. Only patents and

\* U.S. 148, Fed. 2d 416.

the ownership of raw material are unique. Some advantages bring their possessors great power whereas others are of slight importance. Some are nationwide, others are limited to a locality, class, or to a group. No single advantage is sufficient by itself and advantages often offset one another. Gaining one may mean foregoing another. Each concern must choose among an infinite variety of supplementary advantages those which will give it the strongest trade position.

Since each trade advantage is hard to come by, the benefit to be expected from it must be weighed against its cost. When it is considered too expensive, management places its bets elsewhere. Concerns in the same industry develop their own interlocking set and acquire their character through the combination they select. Any attempt to exploit a trade position by charging excessive prices or skimping the product is likely to boomerang. And the forfeit is the loss of the position. Trade advantages, giving substance to the trade position, are the foundation stones for the stability and the continuity which distinguish managerial from free enterprise.

## The Deceptively Simple Problem of Costs

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IN A FREE-ENTERPRISE economy, costs can be estimated with a relatively high degree of precision. When only one or a very few articles are made and the capital investment is small, the costs of material and labor are not hard to compute. Their sum plus a margin for profit closely approximates the selling price to the purchaser.

The theory that marginal costs determine the quantity produced rests upon the assumption of a fixed plant at full production. As this plant is utilized to capacity, overhead expenses remain constant and only direct costs rise with output. Overcrowding and the utilization of less efficient units swell costs disproportionately to output, until a point is reached where the profit margin is wiped out. At this point the price of the product is raised and the demand falls off.

In most managerial enterprises many articles are made and the average investment per worker is large. To compute the cost of operations is difficult, for in addition to the out-

lay for labor, material, research, selling, and the development of new markets, depreciation and obsolescence as well must be calculated. However, to allocate expenses properly is even more difficult. For certain purposes one allocation is appropriate, but for others, a different allocation will be required. While general principles have been evolved with the increasing complexity of industrial organization, it takes judgment to formulate the right method for each objective. The profit and loss sheet is colored by the method chosen.

Each method makes certain assumptions. Many of these are questionable and some even contrary to fact. The only exactness is in the arithmetic. And this very exactness obscures the arbitrary assumptions that underlie the computations. While the estimation of costs is fundamental to the efficient operation of managerial enterprise, the estimate is likely to mislead unless the limitations of the method chosen are understood. The method must be adapted to the needs and fitted to the circumstances of the business and the particular problem to be solved.

Costs may be considered from various points of view. One of the most useful ways of considering them is to separate those incurred for current production from those incurred in anticipation of more effective future production. The costs of buildings and machines can justifiably be spread over many years, so that no single period must bear the brunt. But when an organization is being groomed to enter a new market, any attempt to postpone the costs by capitalizing them is sheer guesswork. On the other hand, if the costs are charged to the period in which they are incurred, current expenses may be seriously overstated.

The cost of testing samples of products as they come off

the assembly line is easy to allocate. The reverse is the case in the experiments on articles that will not be produced immediately. The costs of the Du Pont Company were inflated for years by the experiments that resulted in the perfection of nylon. Many experiments prove abortive, and even when successful they are expensive. General Electric is known as a high cost concern. The chief reasons are its expenditures on research and on benefits to employees. The automobile industry cannot in any one year make more than a few innovations. Too many changes perplex and confuse the prospective purchaser. When Ford switched from its Model T to its Model A, the shift was so complete that he had to close his plants, revamp his machines and processes, then go out after a new market.

The expansion of training classes will eventually make available more intelligent employees. Hiring and training personnel other than those necessary for daily operations raises the wage bill. In order to get superior persons who will be capable of filling positions of responsibility, exceptional material must be found. And then this personnel must be trained, both by class instruction and by routing through all the divisions of the business. During this period they must be paid at a rate higher than the regular workers on the job and are of course less efficient. To say the least, they are a nuisance to foremen and other employees. But the practice may pay when it comes to future replacements. President Eliot of Harvard is credited with the policy of never making important appointments that were just "good enough" or that were "deserved" through long association. Whenever possible, he sought in his appointments to introduce higher standards of excellence.

Every organization carries many burdensome costs which are inheritances of the past, as well as costs intended to facilitate operations in the future. For certain purposes both can properly be distinguished from current costs. Pensions to retired personnel have the double aim of rewarding past service and of stimulating the efforts and morale of the present employees. Machines that were carefully placed for efficient operation under one set of conditions may under another be in the way, but the cost of moving them to fit into the new alignment is prohibitive. Unused warehouses, plants and machinery tend to accumulate. For example, "idle plant expenses" of the United States Steel Corporation averaged about \$2 million per year in 1927-38. Proximity to raw material, which determined the original location of an industry—for example, the furniture industry in Grand Rapids—ceases to have value when the raw material is exhausted. Yet the investment, the concentration of skilled labor, and the social adjustments that have been made will keep the industry there until the disadvantages become too great. The industry then tends to move to another center. The process however is slow and halting. For while the new center has the raw material, it lacks the skilled labor, and the social adjustments have to be made.

Favorable locations become unfavorable with changes in transportation. River towns lost their value as sites when railroads replaced barges. By lessening what were formerly prohibitive costs of transport, motor trucks are creating new sites. Long-term rent contracts often become a burden from which no benefit derives.

A standard division of costs is between production and selling. It is useful and can often be made fairly well. Pro-

duction costs are confined to those incurred in producing the finished article. Selling costs are those having to do with creating or enlarging demand, including all forms of advertising and explaining the use of the article, plus those entailed in closing the transaction—guarantees, delivery, and credit. But at many points, the distinction blurs. There is a saying that an article well made is an article half sold. Certainly, the excellence or faultiness of its manufacture has much to do with the cost of selling it.

Another useful division is that between average and specific costs. The specific costs of an article produced under pressure may be much higher than the average costs of the same article produced on a regular schedule. On the other hand, if the ingredients were procured under exceptionally favorable circumstances, specific costs may be lower. The costs of manufacturing spare parts for future replacement are low when they are made under a schedule of production in conjunction with the regular parts; but the costs are high when the same parts have to be specially manufactured in small quantities. The preparation and adjustments for a small run are almost as extensive as those for a large run. The distinction between average and specific costs is especially important in the tobacco industry. Leaf is bought at various times and at various prices. And many cost items, such as power, labor, and transportation, vary from plant to plant according to its location.

An investor or a government regulating commission is interested in average costs. But the executive before he can formulate policies and determine prices must know in addition how average costs vary with the degree of plant utilization, whether costs are exceptional or regular, and how

much is direct and how much overhead. The necessity of making good a guarantee on a specific order may cause a large temporary loss yet have little effect on average costs. If any new or higher cost tends to become permanent, however, it does affect the average and must be taken into account.

Another method of cost computations turns on the break-even point. This is where total costs equal gross income. Costs are reckoned on a certain expected volume of sales—something less than full capacity. Of necessity the planned volume must be lower than full capacity, for it cannot be expected that at all times facilities will be used to the limit. The capacities of machines cannot be minutely synchronized. Some seasons are normally busier than others, just as some days of the week are busier than other days. At some still lower volume there is a break-even point. This must be attained regardless of consequences. Failure to attain it is such a calamity that specific costs are undertaken recklessly if it is thought they will ensure this minimum volume, for the investment and the organization weigh heavily on management.

Above the break-even point, costs may be computed by either of two methods: Fixed charges may be spread over a larger volume, giving lower average costs for all items. Or after the entire fixed overhead has been absorbed by the break-even volume, further output need be charged only with the specific costs of production. The distinction between these two methods is important. This is for the reason that the method of charging costs leads to different policies.

The first tends to the cultivation of an established repetitive demand, on the assumption that this demand will be sufficient to make the total volume exceed the break-even point and indeed stimulate a volume somewhere near expectations. Management may then concentrate on balancing its operations. The second method originates in the fear that the break-even point may not be reached. If so, desperate measures are called for. To an outsider, the sales efforts will look absurd and so they are under any stimulus save fear. But there is always the hope that the induced demand may create habits and become regular, so that operations may be balanced at a higher level.

A variant of the second method is common, although it is basically unsound. Prices are reduced on regular stock or new lines are added and sold at a price so low that it does not cover their estimated share of overhead costs. A drug-store adds cigarettes and tobacco. This is regarded as 'found' business on which any margin above cost is better than nothing. So it undersells the regular tobacco store. Thereupon the tobacconist discovers that he can induce new business by carrying shaving cream, shirts, neckties, and the like. Any sales of such articles are all velvet to him. By undercutting, however, each is adding to his business at the expense of the other. Both are doing poor jobs. Both are carrying incomplete assortments. At first, it is merely a matter of pecking at the other's established line. But when the new line crowds out the old, which had been relied on to cover overhead, the apparent gain through this 'found' business becomes illusory. Such an admixture is unhealthy for both dealers, and gives the public no compensating advantage.

Siegel-Cooper, long remembered for the slogan "Meet me

at the fountain," adopted an analogous policy. They selected several departments to run at a loss, with the idea of giving a general impression of low prices. Their hope was that the customers enticed into the store by the low prices would buy freely in their profitable departments. The first part of their scheme succeeded only too well! Their losing departments flourished so expansively that the deficits they registered could not be offset. The second part of the scheme fell flat. The public took the bait but left the hook. And the end was bankruptcy.

This discussion may have given the impression that the margin between success and failure, turning as it does upon the attainment of the break-even point, is narrower than is the case. Normally, there is a fairly wide margin between the volume of production needed to break even and plant capacity. Businesses absorb a large drop in volume before continuity is seriously threatened. And much can meanwhile be done to restore a balance. An energetic management has wide latitude to turn when in trouble. Other sources of business can be tapped. Expenses can be cut. While a distinguished success depends upon the utilization of full plant capacity, there are degrees of success below that. Before a business actually goes on the rocks the slack of all kinds that can be taken up is considerable. Many businesses just manage to keep their heads above water by adroit postponements until a favorable turn of the tide carries them out of danger.

The costs of a growing organization are always greater than those of one that is static. Expansion throws the com-

ponent parts of the organization out of balance. Management is put to it to restore the balance at a higher level. If the expansion is forced by increased demand, productive facilities must be enlarged. This entails many adjustments as well as the addition of units. New employees must be trained and absorbed into the working force. An airplane transport company for example laid its loss during the 1946 postwar period to the training of new pilots in preparation for heavier traffic. High costs are not necessarily a symptom of inefficiency. They may signify progress. Anticipating later success, Saks Fifth Avenue was content to run at a loss for several years when it first opened. It took time for shoppers to adjust their habits and become accustomed to buying in the then new establishment.

Management must be sensitive to changes in consumer demand. Also, the organization must be kept flexible. This is expensive. When one source of demand dries up, another must, if possible, be substituted. In the tobacco industry there is a current saying that when a cigar smoker dies, there is one less cigar smoker in the world. Every store that hopes to survive must not only look after its old customers but also attract the new. Traditions stick. Every manufacturer must always be on the alert for new designs and better materials. But the search for novelty may go astray as it has in the china industry, where the slightest modification of an old pattern is introduced as something new.

Management must school itself to accept the costs of building up and maintaining trade advantages as inevitable. In some cases this expense runs as high as three or four per cent of gross income. Reputation, an intangible trade advantage, is built up stone by stone. One stone is the guaran-

tee. When boilers delivered to the Navy proved unsatisfactory, the firm that sold them had to make good. It put its finger on the defect in time to save its reputation, but went into the red for the year. After it had started manufacturing a new model, an automobile company recalled and replaced an entire year's output of carburetors installed in the preceding model, which subsequently gave trouble.

Another stone is service. Some stores find it good business to permit a customer to take with him and charge to his account any article worth up to five or ten dollars. The consequent losses, which are small but regular, are more than offset by the good will gained by trusting the many honest customers. Similarly, stores go to the greatest trouble in filling special orders, no matter how small. Manufacturers take orders in one-twelfth of a dozen. The costs are often so high that they lose on the individual transaction, but they enhance their reputation for service, and the total cost stacks up to a trifling amount.

A third stone is prestige. To keep its position as the center of New York's social life, the Waldorf-Astoria had to move uptown from its original location on Thirty-fourth Street. For certain purposes, such as banquets, meetings, exhibitions, it has an almost unique advantage. Hotels with more modest ambitions do not have to pay the enormous rent a prime location commands nor do they have to be so commodious or well-staffed. In certain other industries, too, prestige of location is vital. If it is, it must be had at any cost. A purchaser who is willing to go out of his way to what in real-estate vernacular is a 60 per cent location can usually find lower prices.

Prestige is won also in other ways. The premier dealer in

rare books must buy first issues or first editions whenever they come up in auctions. His leadership in the trade is at stake. In order to hold it he must buy a Gutenberg Bible or the Bay Psalm Book regardless of price. Fashion stores must always have the latest creations from Paris or Hollywood. The cost far exceeds that which meets the eye, for many models bought are not quite up to scratch and have to be discarded. In their desire to make a scoop, newspapers frequently send reporters to places where events might, but do not, happen. The scoops that heighten the reputation of a paper are the happy outcome of a few among many attempts.

Large cash reserves reckoned as a part of costs are the only safeguard against chance misfortune. How large they should be depends upon the temperament and judgment of the management. It is difficult to say where prudence ends and timidity begins. So far as managerial enterprise relies on a precise estimate of cost, it has a shaky foundation. The efficiency experts who are hired to reform an outdated management often do more harm than good. Yet they seem so unassailably correct in their uncovering of waste and so sure of their modern technique. The determination of which expense items are properly to be charged against which operation requires intelligence and experience, not formal logic and invidious comparisons. Depreciation can be approximated closely enough for a rate to be established. Obsolescence, on the other hand, is due to a variety of fortuitous circumstances.

Other costs are also unpredictable and are best guarded against by insurance. Most dramatic in recent years have been the misfortunes that piled up on the Ringling Brothers-

Barnum and Bailey Circus in connection with the fatal fire at Hartford. Another example of expenses descending out of the blue was involved in the change in ownership of a large building which had served its purpose for over thirty years. A routine examination by engineers indicated that it was under strength, and further investigation confirmed their opinion. The original records and permits were checked and found to be in good order. What had happened was that some years after the original construction three floors had been added, but the columns and supports had not been reinforced to bear their weight. As all those directly responsible had long since died, there was no recourse against them. Because the building was used daily by thousands in all innocence, it was necessary to remove the upper stories. Fortunately the building did not collapse, but the cost to the new owners was huge.

Though it is considered sound practice to minimize losses by keeping small inventories in times of shrinking values, from a practical angle this is unsound, for the reputation of carrying a fine stock is more important than the expected loss. Over against the few occasions when normal inventories have been decreased to forestall losses can be set the great majority of occasions when insufficient inventories have given rise to a myriad of intangible costs—ill will, small repeat orders, and the extra expenses entailed in work stoppages, delays and extra efforts. Within a wide margin, inventory depreciation is the lesser of the two evils. An old saying has it that the only articles that improve with age are liquor and friendship, and even these have to be nurtured.

In any consideration of costs, the cost of buying is usually neglected. It can be minimized but never eliminated and at

times it may be substantial. In the case of the consumer buyer, it is disregarded; in the case of the commercial buyer, it is underestimated. The fact that the cost to the buyer is always greater than the actual sales price postpones or prevents purchases. Large organizations usually have a purchasing agent, who studies the opportunities to fill needs and who searches out and classifies the most likely sources. Laboratories are set up for testing and comparing the qualities of different products. The total costs exceed those shown in the accounts.

Distributors attempt to render the purchase of articles by consumers as easy and painless as possible. Charge accounts, displays, wide assortments, services, store shoppers are all directed to this end. In busy periods costs can properly be computed as an average in terms of transactions. In slack periods these costs of facilitating purchases may be unduly high. Average costs are out of proportion to specific costs when policy requires a superior standard of service. Then the minimum staff necessary to cover a given area is an overstaff in terms of transactions.

The disregard of the cost of retail buying may be due to several things. For example, most purchasers are housewives. They are unpaid and not accustomed to thinking of the value of their time in money terms. There is often a spirit of adventure in shopping around and this is regarded as fun. Seeing and handling new objects are ends in themselves. Spending money gives a feeling of elation.

Cost accounting is a direct offshoot of managerial enterprise. By its allocations, management can rationalize almost any course of action or justify any extravagance. Executive decisions require the particular computation of costs appro-

priate to the particular situation. But too often accountants create their own formulas of costs from generally accepted principles. The proper formula must be selected in accordance with the practical application of policy and not according to abstract theories. The pulsing necessities of the business in hand must be met by definite acts. An estimate of costs is a valuable but slippery tool.

## CHAPTER

# 7

## The Pattern of Prices

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WHEN FREE ENTERPRISE develops into a system of production and distribution, prices cease to be fixed impersonally on the market place. Rather are they administered in accordance with policies. To find the price that is in tune with the necessities and that contributes to the successful balancing of all the operations is a fine art. An administered price is one that is fixed by management after a careful survey of all the factors involved—the expected demand, the cost of production and of selling, the price of similar articles, the general price level, the pricing policies of the concern and its position in the trade. Management's hope is that this price will remain unchanged for a considerable period—say a season or a year.

The policy underlying administered prices is coordinated with the other policies of the concern. Reflecting the degree of intelligence or, perchance, the accuracy of the hunches of the management with respect to the extent of consumer demand at different price levels and the technical possibilities of mass production to reduce costs sufficiently for

profitable sale at these various price levels, the policy integrates the business to fit the market situation. Such policies are not pulled out of the air. On the contrary, they are carefully designed to square with realities and to take advantage of potentialities. The questions considered in arriving at a price policy are discussed in detail below. It should be borne in mind that only the prices of commercial articles—those that can be freely reproduced and sold at prices that meet the current demand—can be described as administered.

The law of supply and demand, which was formulated in an economy of scarcity, becomes the law of demand alone in an economy of plenty. Only by torturing theory can the process by which commercial articles are priced be pulled into line with the factors determinative of the price of free-enterprise articles. Commercial chairs can be reproduced at will, but there are just so many antique chairs in the world. The prices of the two obey different laws. The prices of articles dealt in on exchanges and at auctions fluctuate continuously and over a wide range, the price paid depending upon the personal position of the seller and purchaser. The price paid may have little to do with the commercial or resale value of the article, for it depends upon the ability of the prospective purchaser to pay and his desire for a particular article because it fits his immediate needs. "Dealing" or "auctioneering" requires nimbleness of wit, personal salesmanship, sensitivity for fine distinctions, feminine intuition, rather than the more rugged qualities connected with merchandising. The late Joseph P. Day was a great auctioneer. He had a dramatic gift for suggesting possibilities, creating an atmosphere, promoting enthusiasm for

plots of land and urban developments which would otherwise have remained stagnant.

Essential to an understanding of administered prices is a realization of the relative positions of the seller and the buyer. It is a mistake to overrate the power the vendor derives from initiating terms. The price at which he offers his wares must be within the reach of his customers. He is always at a disadvantage with respect to the purchaser. At every stage from the buying of raw materials to the buying of consumer goods, the purchaser is king. The seller has an article or a class of articles which he must sell. His solvency depends upon these specific articles and no others. Behind him is an organization that is continually producing more. And it is the flow of distribution that makes it function.

The purchaser, on the other hand, has money in his pocket and can choose among a great variety of articles to satisfy his needs. Having chosen the article, he has a further choice among types or brands. Though the range of choice may be narrow, there is almost always some choice. And often he can postpone purchasing.

The primary sellers are the producers of raw material. Wool, cotton, linen, silk, rayon, and nylon are in many instances adaptable to the same use and afford a breadth of selection to weavers and finishers. Aluminum, copper, nickel, iron, tin, and alloys all compete with one another in the manufacturing of metal products. Fruits, vegetables, fish, and meat present an infinite variety of choice to canners.

There follows the manufacturer. Having chosen the raw materials he wishes to put into his product, he can no longer substitute one raw material for another. Once committed

to a certain product or line, he loses his freedom of action. He focuses all his efforts first on perfecting his particular type of brand and then on disposing of it.

The distributor is the next in line. He can select among the products of many manufacturers the one he thinks will most appeal to his customers. He need not carry them all. And he can drop any line when it ceases to fit in with his purposes. He lords it over the manufacturer until he too has committed himself to a particular line of goods. Despite his relative freedom of choice, he is likewise under pressure to sell. Only through sales can expenses be covered. In his turn he loses his advantage when he offers his wares to the final consumer. He must utilize his skill to the utmost to demonstrate that his particular articles will satisfy his customers' needs better than other similar articles. A distributor cannot afford to operate a museum.

At the end of the line is the ultimate consumer. Since he is the only one who buys for use, he can choose among different types, different makes, different colors, or he can refrain entirely from purchasing. He is as free as air.

However, in an economy of plenty, one limiting condition applies to all purchasers. The edge the buyer has on the seller may be whittled away. And this indeed is the prime objective of salesmanship. The seller brings pressure on the buyer in every way possible—by creating demand through forming habits, advertising, demonstrating, "full-line forcing" and tie-in arrangements. Because the power of the seller over the price of freely reproducible articles is contingent upon the consumer, the terminal points of this power over prices are automatically set. The price must be within the range of demand to ensure as steady a flow of

purchasers as the nature of the article permits. Large sales are attained when the price is right for the particular clientele. Only in cases that might properly be termed monopolistic or in the exceptional situation of scarcity does the advantage pass to the seller.

#### FACTORS DETERMINATIVE OF ADMINISTERED PRICES

Is the article consumed when it is used, as are coal, firewood, food, soap, gasoline, kerosene, or ammunition? If so, the price must be such that the buyer feels he has received full value though nothing is left. The principle of pricing single-use articles spills over into those having two or three uses before being consumed.

Not far removed from single-use articles are those used in production and consumed in the process. Many finished products are elements in other finished products, as for example, boxes, wrapping paper, string, cellophane, cloth, nails, and paint. In one sense they are akin to the raw materials entering into manufacturing, but they have a wider range of alternative uses.

Is the article so durable as to have a series of uses, in some cases over many years? Since, to realize its full value, a certain cost of upkeep must be taken into consideration, the original price is recognized as a first cost to the purchaser. The higher the cost of upkeep, the less important is the price. Typical are capital goods of all kinds in the hands of both producer and consumer. If their quality is not apparent and can be ascertained only in performance, a guarantee must be given. Market resale value and frequency of use are other determinants of price.

In normal times durable and semi-durable articles are on hand in quantity. In contrast to immediately perishable articles the annual output is a mere fraction, a tenth to a fourth, of the existing supply. Anyone who has what he needs of a durable or semidurable article is not a potential purchaser at any price. Only if he loses it, wears it out, or a vital improvement makes it obsolete, will he consider buying another. Even when the old is dilapidated, he can make it do a bit longer. Shabby articles are still useful. Necessity is rarely the reason for buying a new rug, a new house, a new automobile, a new fur coat, a new lamp, or a new refrigerator. Durables and semidurables are paid for out of savings or windfalls, rather than regular income. This ability to postpone purchase puts pressure on the manufacturer from the demand side. For his continuity of production always depends upon continuity of distribution. He adjusts his operations and his prices as best he can. But there are limits to what he can do. In periods of slack demand he may be forced to close his plant.

In 1941 there were twenty-six and a half million automobiles in the United States. Yet in 1945 twenty-four million with many added years of use behind them sufficed for all essential transportation. Consumers could get along with fewer shoes and suits in their closets. Their standard of living would be lower and some would lose the self-assurance that comes from being well-dressed. Installment buying has increased sales by making possible purchases out of regular income that would have otherwise been postponed.

After all other methods of stimulating purchases have been tried, sellers are confronted with the alternative of maintaining prices in the face of smaller demand or of re-

ducing prices. To cut prices will cause a break in the market and disrupt the price pattern. What further ramifications may ensue are unknown. A temporary loss through curtailing production, provided it is temporary, is preferable. And so sellers hold off. It is better to maintain the customary ratios as long as they can. Finally they can evade the necessity of a choice no longer.

There is danger either way. If sellers hold for a long interval, styles may change, and the article become obsolete and unsalable at any price. Meanwhile manufacturing costs may be reduced and prices become stabilized at a lower level. On the other hand if sellers attempt to clear stocks immediately at any price, confidence in the pattern of prices may be damaged. On a falling market people wait for still lower prices, and demand is dormant. Gradually strains develop. One price eventually breaks and all break. Inventories pile up, losses mount, and the fears of businessmen are confirmed.

In 1930-32 for example, inventories were dumped at unprecedented prices. These became the regular prices until they in turn were succeeded by new lows. That was an avalanche. But there is always a trickle of discrepancies to be corrected. In ordinary times this trickle is absorbed by the adjustment of prices and stocks to changes in demand. Losses are localized and the market structure remains intact.

How long can the article be stored? Those that can be stored are not subject to the vagaries of immediate circumstance. Their prices can be named more confidently upon a broader base of estimated demand. However, even they begin to deteriorate eventually. The time allotted for their

orderly disposal, though long, is not indefinite. Also the cost of storage is small but constant and must be taken into account. Objects vary greatly as to the intervals during which they can be stored without deterioration. The semi-durable and durable goods that are impervious to deterioration are few. China and glass chip. No matter how well packed, fabrics crease, fade, and suffer from infiltrating dust. Metal loses its sheen and if stored uncovered, it rusts and flakes. Each time an article is moved or repacked, there is the possibility that it will be scratched, if nothing more. The mere cataloguing of articles in storage is no small task. It is easy to mislay packages. On one occasion known to the writer an entire box of silk stockings bearing a date thirty years earlier was found in a storeroom.

Is the article an entity in itself or is it an accessory? Portions of all kinds of machines and replacement parts generally are examples of accessories. So likewise are subsidiary parts such as automobile tires and spark plugs, window panes, white and black ties for evening clothes, radio tubes, and electric bulbs. In this connection in *Cartels in Action*, G. W. Stocking and M. W. Watkins show how little a change in the price of crude rubber could affect the total price of an automobile:<sup>1</sup>

The inelastic demand for rubber contributed to the phenomenal rise of prices. Tires and tubes for the rapidly developing automobile industry provided the major source of demand for rubber. In these uses rubber has no substitute. Tires and tubes are only a minor part of the cost of the motor vehicle, and the crude

<sup>1</sup> Stocking, G. W., and Watkins, M. W., *Cartels in Action* (Twentieth Century Fund, 1946), p. 59.

rubber required for their manufacture a much smaller part. Even doubling the price of crude rubber would scarcely deter a prospective purchaser from buying an automobile.

The lack of a part impairs the usefulness of the whole. Thus is caused a loss out of all proportion to the price of the part. A part has little intrinsic value. Rather its value is one at a specific time and place. The demand for parts is irregular and the costs of carrying stock are high relative to the costs of manufacture. In large distribution centers the places where parts are sold are so concentrated that the demand for them can be estimated. However, the cost to the purchaser of finding and getting them may be large. Demand for subsidiary articles is also limited. They are wanted for certain derivative purposes and not for their own sake. Yet when they are required, the demand is urgent, no matter how much they cost. With such articles, the demand for which is conditioned by their use, any change in price can have no effect on demand. People buy them as they need them.

What role does fashion play in the demand for the article? Fashion curiously combines fickleness and stability. Closely related are the vogue, the style, and the fads that come and go. In many cases, cycles in fashions can be accurately forecast by noting trends. Women's apparel follows a definite cycle. Often, however, vogues are started by chance—a victorious general wears a beret, the President a certain type of bow tie, or the First Lady favors blue. The younger set copy the hair-do of a suddenly popular film star, use her brand of perfume, and wear her type of shoes.

The fashion magazines, newspaper supplements, and advertisements set the pace in these matters.

Some changes in style are due directly to the mechanics of living conditions. The high temperatures to which dwellings and offices are heated make for lighter and fewer clothes. Dust coats and voluminous chiffon veils went out when the closed automobile came in. Other changes seem to be due to the new political and social status of women. Their entrance into business and the professions is reflected in their dress. All this seems to have begun with Amelia Jenks Bloomer in the middle of the nineteenth century but the movement has accelerated since World War I. Occasionally one meets a prim elderly lady dressed in a mode that brings back the days before women were enfranchised.

Fashions determine the methods by which women's apparel is priced and merchandised. Sales of highly styled women's shoes, costume jewelry, and dresses follow a regular seasonal pattern. Articles are introduced at a maximum price which is paid only by those who pride themselves on always wearing the latest. After the height of the season a broader market is sought. The novelties that found favor and were accepted are now safe. They may be made and sold in quantity at lower prices. Toward the end of the season remnants are closed out for what they will bring. If plans work out and all goes well, the average price covers the costs and shelves are clear for next season's models.

Like fashions, habits are at once constant and fickle. Year in, year out, amid all the vagaries of modes and fashion, black is the best-selling color while dark brown and blue are next. Patterns of china long-forgotten are still sporadically called for, and a few ladies still wear cashmere shawls.

Petticoats, red woolen underwear, and ascot ties are occasionally and urgently in demand. It is always possible and at times profitable to be the sole specialist in the fashion favorites of yesteryear.

Less obvious shifts occur in other fields. For instance in the twenties there was a great vogue for carved and gilded wooden floor lamps, with wide-fringed silk shades. Exceedingly ornate, they were considered a mark of distinction by a certain class, for they were expensive, ranging from twenty to fifty dollars. Suddenly a light metal stand with a parchment shade came on the market. This one was relatively inexpensive, and the big demand came from customers who were willing to pay from four to fifteen dollars for a lamp. The manufacturers and merchants in floor lamps with wooden bases had to liquidate their stocks. Great sales were staged with prices set from ten to twenty dollars. They were astonishingly successful. Thousands of lamps were sold in a day. Obviously a great many people who had yearned to own a wooden lamp had not heard that the style was on the wane. They satisfied their longing, only to find later that the prestige value had disappeared. But the paths of commerce had been opened for a vigorous selling campaign for the new metal lamps.

Is the article purely one of utility? If it is, fashion does not enter into its price. Its price tends to be low, based on cost. The manufacturer has less need for a trade position. When baking was done at home, Gold Medal, Hecker, and Pillsbury *xxx* flour were sold to housewives on their reputation whereas today flour is sold to bakeries on specifications. Work shoes, work clothes, bricks, specialized machinery, steel bars, thread, tools, plows, semifinished articles and

most raw materials are priced and sold on recognized standards of performance. Values can be measured and compared. The distributor or manufacturer buys such articles after testing, and the final consumer relies on the dealer's reputation. As demand is broad, waste in production and distribution can be minimized. On the whole, more and more articles bear brand names.

Occasional attempts are made which sometimes succeed to lift an article out of the pure utility class by introducing a fashion element. Distinctive touches are applied to these utility articles. "Color in the kitchen" was a slogan designed to make the kitchen as attractive as the other rooms. House dresses were infected at one time with the mysterious lure of the artist's smock. Linoleum was dressed up with a luster all its own so that it gave the effect of tiles. Articles with pleasing lines are more salable even if no more useful than clumsy articles. Standard foods and drugs are easier to sell if the container has a handsome and distinctive label. At present the emphasis is on function. No matter how beautified, the value of utility goods still remains in their performance.

Even utility articles change over the years. Water-borne freight has been powered by everything from sails to Diesel motors, longer trains and higher speeds create a need for heavier steel rails and bridges, new requirements are set up for construction materials.

Some few articles remain exactly the same for decades. But this is not true of their place in the economy. Checked cotton gingham by the yard has not varied in count or design. While formerly it was standard for curtains, dishcloths, and aprons, today it becomes from time to time

fashionable for evening dresses. Though the changes in this most stable sector of our economy seem slow, they have so cumulated in a single generation as to make pre-1914 products look antiquated.

What is the breadth of demand? Is it widespread or is it confined to a small class or group? Articles of general use must be made to sell at a price within the range of persons having moderate and low incomes, and not directed to a specific class or group. Such articles must move in quantity, which implies a "yes" response by the millions. Dresses, both house and street, are designed to sell at standard prices, \$3.95, \$5.95, and \$9.75; men's shirts at \$2.00; shoes at \$4.45; men's suits and overcoats at \$19.00 and \$29.00. Radio sets are built into cases which are constructed to sell at or under specific prices. Soft drinks, chewing gum, and candy bars were made to sell for a nickel or a dime. Pocket editions of popular books were issued to sell for a quarter. *The Saturday Evening Post*, *Collier's*, *Life*, and *Reader's Digest* have a universal appeal. As long as possible, the price of each was a single coin—a nickel, dime, or quarter. A class magazine such as *Vogue*, *Fortune*, or the *Atlantic Monthly* does not have to bother so much about a price that is confined to a single coin.

A change of price is a nervous affair. The perfect price cannot be reasoned out. The only guide is public reaction which is discovered by trial and error, as the following excerpts taken from the *Publishers' Weekly* illustrate:<sup>2</sup>

Anxious to learn whether the public will accept a 35-cent price for the now traditional paper-bound re-

<sup>2</sup> *Publishers' Weekly*, Dec. 28, 1946.

prints, at least one publisher, Bantam Books, is carrying on tests in certain cities. Bantam is trying the 35-cent price in Wilmington, Delaware, and Columbus, Ohio, and began with the November releases. It is still too soon to draw any conclusions as to the effect of a higher price on velocity of sales, but Bantam expects to have a report in a few weeks. Bantam is quite open-minded about it, and the test is definitely not the result of a decision to change the price, but an effort to learn what might happen if the price were changed. "It's an honest-to-gosh *test*," Arthur Hale of Bantam emphasizes.

Dell Publishing Co., according to George T. Delacorte, Jr., does not plan any tests; Mr. Delacorte, whose firm sells 15,000,000 magazines a month, and therefore feels it knows a bit about the behavior of the newsstand market, thinks that the paper reprint publishers may very well "price themselves out of the market" if they increase their prices to 35 cents. "It's one thing to increase the price so as to break even," he tells us, "and it's quite another thing to get the public to buy at the higher price."

Eye appeal is important in the stimulation of mass demand. An article's qualities must be obvious. Furniture sells more readily if it has an appropriate scroll or design—possibly a gold line—than if it is severely plain. Even gasoline motors look better if they are covered with a coat of shiny paint. Automobile manufacturers found they could not economize by leaving off chromium ornaments, without losing public acceptance.

Quite different are the articles made for a specific group or class. Fishing tackle for anglers, religious trinkets for the devout, diamonds for fiancées, expensively simple clothes for the inheritors of wealth, dental instruments for dentists, and surgical instruments for doctors—in all of these the sales are limited by the size, fervor, and strength of the group, rather than the nature of the article itself. Thus a conservative men's clothing establishment with an enthusiastic and loyal group of customers accustomed to high prices refrains from adopting a policy of expansion on the ground that it would sacrifice the qualities that attract their customers. It believes it would lose its restricted but preferred position if it attempted to widen its clientele.

Before such articles are priced, the characteristics of each group are studied. Price is less important than the qualities of the article. Indeed the high price may be an asset in promoting an aura of exclusiveness. But the snob appeal has to be handled with perspicacity. It has definite limits. Even within groups there are strata. Boys on the banks of a pond, searchers for recreation, the select enthusiasts for tarpon and salmon are just as much fishermen as the professionals. The tackle must be designed to appeal to and to suit each stratum.

Sometimes astute salesmanship can make the same article do for various groups. Soap can be sold in a cheap wrapper at ten cents a cake or in an expensive one at twenty-five. Blue denim work pants at a dollar become exclusive when they are faded or a red stripe is added and they are nicely wrapped in cellophane to sell at two-fifty. Perfumes out of the same vat are sold under different names, in different bottles and at varying prices. From a merchandising angle

this apparently sharp practice is simply adjusting the package to the type of customer who considers a low price a mark of inferior quality.

How frequently is the article purchased? With frequency of purchase, the price becomes fixed in the public mind. Then any change in price must be explained. Customer confidence feeds on stability. The price itself is not so important as the fact that it is always the same. The chain of production always leads to the distributor. It is he who has to face the public and bear the full brunt of the resentment against price changes. By experience he has learned to fear consumer resistance, and opposes a rise in prices. When aroused even a small proportion of the public can make such an uproar that prices have to be reinstated at their previous level, regardless of loss.

The guardians of low prices love to shop around and complain loudly. Frequently they know the market better than the merchant—particularly as it affects them. While the average buyer goes to the accustomed shop, this group makes a business of investigating and comparing values. It is ever on the alert. It has a tremendous nuisance worth, which operates to the benefit of the public especially with respect to articles that are frequently bought. A buyers' boycott is a forceful weapon, for a customers' picket line is an uncomfortable prospect for any merchant to contemplate.

On quite another plane are those articles purchased only at long intervals or once in a lifetime, for example flat silver, fur coats, china, desk sets, fine rugs, lithographs, lounging chairs. Here the customer does not compare values meticulously. Differences in value are not obvious and he must

rely upon the general reputation of the maker or dealer. The sentiment, vanity, and desire of customers to keep up with their neighbors make them susceptible to the appeal of prestige. The less sure one is of one's own judgment the more one relies on reputation.

But reputation is more of a strait-jacket to the merchant than the customer thinks. The merchant's ability to take advantage of a customer's lack of knowledge is limited by the occasional expert. For while the great majority of purchasers may be relatively blind, from time to time an expert comes along who is as capable of fine appraisal as is the merchant—perhaps more capable. Should he find the price too high or the article inferior, his opinion will start a wave of suspicion that will ultimately undermine the merchant's reputation.

Is competition direct or remote? The various brands of hand soap and washing powders are examples of the most direct competition. They are usually displayed side by side and their qualities are well known. Purchasers take the one they prefer for some personal reason. Certain brands and lines have always been known to distributors as being more competitive than others. Price wars are usually concentrated on them. When competition is direct on unbranded articles prices tend to become unhealthily low.

The case of aspirin is interesting. Although the ingredients of all brands are enumerated as is required by the Pure Food and Drug Act and competition is apparently fierce, Bayer's has won such popularity that it commands a much higher price than any other brand. Competition has only a general effect on the prices of most branded articles. Prices of comparable articles must be more or less equal,

but need not be exactly the same. Slight variations go unnoticed even by professional buyers and experts, for they can compare prices in only a small part of the market each day. These variations are not due to any studied design on the part of producers but are the inevitable result of the application of different policies by price administrators. Many prices are based on an average arrived at by lumping together the costs of other, quite different, articles. The formula thus applied will not fit the actual cost of the specific article. In other words managers have broad classifications of goods into which they fit the specific article and the resultant price will vary according to the class to which it is assigned.

What is the effect upon prices of trade habits, customs, conventions, and understandings? These are at times a powerful influence in setting prices. They may dominate the pricing of articles infrequently used and made by established concerns on the fringe of commerce. They may be paramount with manufacturers of fine china, fine rugs, and fine furniture, as long as each thinks he is getting a fair share of the total for the industry. Purchasers are ready to pay high prices for this type of article.

The price is arrived at by obscure methods of reckoning having an historical rather than a factual background. Whether it is sanctioned by time, set by a formal and possibly illegal agreement, or by an accepted leader, it has little if any relation to the costs of manufacture. As it has a vague relation to what has come to be considered a fair price, anything less is denounced as price cutting and anything more as profiteering. The cutting of prices below prevailing rates is deemed poor practice because it reduces receipts substan-

tially yet does not increase sales. Moreover competitors can also reduce their prices and the end would be common loss. A main factor in holding the price pattern is fear of what others might do with their power to wage a competitive and disruptive warfare. The prices that emerge from these unusual methods give opportunity for large individual gains, but the total is petty, for in this field the market is small.

#### THE DYNAMIC EFFECT OF PRICE

The prices set under these diverse circumstances are neither the result of impersonal competitive forces nor are they authorized as in collectivist industry. They are arrived at after careful study of all the questions enumerated. Their aim is to stimulate buying. Under no interpretation is the price named the only one under which a managerial enterprise could operate. The choice of practicable policies is wide and management has considerable latitude in the emphasis it places on each policy. The price conditions the organization itself. It is an integral part of the whole. There is no criterion by which a price can be judged right or wrong except the success of the business and the social benefits it brings. And these two may or may not coincide. Another price might have activated an expansion of demand giving the concern an equal or greater profit. There is ample room for argument, tests, and differences of opinion.

Chain stores and especially supermarkets have built their establishments, organizations, services, and the assortment of goods carried, around their low-price policy. When the Woolworth Company started, its entire system—merchandise, service, accounting, location, packaging—was all in

line with its five- and ten-cent price policy. When it broadened its operations to include articles at higher prices, it had to make numerous delicate adjustments. Before 1916 the Gillette safety razor was a luxury finished in gold or silver plate and priced to sell at five dollars or more, even as high as seventy-five dollars for a superfinish. The enormous demand brought by World War I was met by quantity production of an inexpensive holder, priced to sell at a dollar. As safety razors became more popular still further reductions of cost, especially in blades, became possible. To satisfy this mass demand the entire organization and its methods had to be realigned.

A business may be organized to stress breadth of selection to suit individual preferences together with service and deliveries rather than price. When manufacturers own a brand name and go to great lengths in popularizing it, their interest is concentrated on achieving a wide distribution. Uniformity of price at a level that induces many distributors to display their products is more important to them than low price. When chains and other low-price outlets sell branded goods at cut rates, higher-price outlets will refuse to carry the goods thereby narrowing their distribution. The clash between catch-as-catch-can methods of unfettered freedom at each stage of the production and distribution process and the orderliness of fixed prices finally culminated in the Miller-Tydings Act.<sup>3</sup> This legislation permitted manufacturers of trade-marked articles to set the resale price.

The Aluminum Company of America illustrates many of these problems in the raw. While its price policy contrib-

\* 50 Stat. 693; 15 U.S.C.A. 1.

uted to the internal equilibrium of the company it was alleged that a lower price with larger output would have been equally sound and would have induced wider use of aluminum. That may be. Such questions are complex and the advantages and disadvantages of a different policy extremely difficult to balance. Unless driven, management tends to leave well enough alone. Moreover in the opinion of Judge Learned Hand<sup>4</sup> in *Aluminum Company of America vs. U.S.* the profits of the company were not excessive. Competition in magnesium, copper, and steel alloys was not immediate but remote. The management could not have foreseen the tremendous demand the war would occasion.

The Ford Company built its Model T against the price at which demand concentrated. By turning out the same model year after year, it could manufacture cheaply. This furnishing of low-cost transportation without frills worked for many years. But when demand for higher priced cars increased, Ford lost his big market. He closed his plant for months, undertook extensive retooling, brought styling, colors, and engineering up to the minute in every detail and then came out with a completely new model. The price was higher, but still within the range of demand, and he regained his position among the leaders.

No merchant can raise or lower his prices by a blanket per cent without playing havoc with the price pattern. The demand for some articles will not be affected but that for others will be seriously altered. However beneficial government price control may be from some angles, the dislocation it causes in relationships can scarcely be overestimated.

<sup>4</sup> U.S. 148, Fed. 2d 416. For further discussion see Chapter 10.

Abstract regulations yield a series of prices that do not jibe with the requirements of commerce especially when based on a past period, for conditions of manufacturing, style, demand, and costs have meanwhile changed.

The dynamic force of price is lost unless it is administered with intuitive perception of secondary effects on the concern and indeed the entire economy. These interrelations and influences of prices must be watched constantly. In the telephone system, the relation of long distance to local calls and of single to party lines, have to be kept in proportion by every practicable device including price policies. The functioning of the system is always breaking out of bounds and then being brought back again.

Freight rates for different commodities and between different points are the subject of long conferences at which the necessary adjustments between internal and external conditions are discussed. Any drastic change brings disorder to these relations. An interesting case in point was the refusal of the Interstate Commerce Commission to reduce the freight rate on salt from Louisiana, because a lower rate would have been out of line with other rates. Said the Commission:<sup>5</sup>

It is clear that the rates from the several salt-producing fields to the consuming points should be related. A proper rate relationship between competitive groups is in many respects of greater importance to the shipping public than the measure of the rate itself. (Coal from Detroit, Toledo & Ironton R.R. mines 64 ICC 564.) In the present proceeding we have before us the rates

\* 66 I.C.C. 81, p. 82.

only from the Louisiana mines to certain destinations, and the record does not afford a satisfactory basis for determining lawful rates on this traffic. But we think that the interested producers, carriers, and consumers of salt should confer with a view to establishing a satisfactory rate structure, giving due consideration to such elements as distance and territory traversed, competitive conditions, carload minima, and whether rates and minima should be provided for package salt differing from those for bulk salt.

Once a price has been fixed it becomes known and enters into the fabric of economic life. Holding the price is often wise even in the face of fluctuating demand. The restless initiative of entrepreneurs who introduce new products upsets established demand and price in other fields which are apparently far removed. An improvement in the quality and design of inexpensive pottery has an obvious effect upon the demand for fine china. So likewise with the introduction of stainless steel kitchenware upon the demand for aluminum and enamel dishes.

Occasionally these innovations, despite their apparent superiority, run into ancient prejudices and never make any headway. In the home, metal furniture has never replaced wood. For many purposes wool is the only material that can be used. Indeed for some purposes only certain types of wool are suitable. Mattresses on the contrary can be made of kapok, rubber, cotton, hair and with or without inner springs. In some uses cotton competes with linen, in others with silk and rayon. Up to a point, price ranges for each of these staples, and for the articles into which they enter, are

related. The effects of competition between similar articles, and even between related articles, are immediate.

When apparently non-competitive articles compete for the satisfaction of the same need their diverse drawing powers are difficult to analyze. To what extent did advancing the date of the annual automobile show from February to November affect the Christmas demand for presents? It is said that the plight of professional musicians can be traced to the spread of the radio and recorded music. But what relation is there between the sale of electric household refrigerators and the number of restaurants? When good roads and automobiles open up new country the demand for shotguns, lunch baskets, and sporting goods is increased. Leisure and the means to go places lessen interest in beautifying the house and garden. Suburban and even rural sites become accessible to factory and office workers. The increased price of meat has been related to the raising of minimum wages which has enabled a great many persons to eat more meat and purchase better cuts.

The formal stability of prices is misleading. Every other expedient is tried before prices are tampered with. When surplus stocks have to be worked off, the objective is to create as little disruption to the price pattern as possible. Goods may be marked as seconds and offered at lower prices. A new outlet apart from the regular market, such as Filene's bargain basement or a cut-rate store is sought.<sup>6</sup> Or a new brand name is put on the goods so as to break the connection with the established brand. Surplus articles may be

<sup>6</sup> In the basement of Filene's, in Boston, if an article is not sold after a certain period, its price is automatically reduced. If, after successive reductions, the article still remains unsold, it is given away to charity.

dumped abroad. Special inducements such as rapid delivery, deferred payments, thirteen to the dozen, extensive advertising and mammoth displays may be offered. Such concessions never get into the records. Not until management is sure that the old price pattern is no longer possible does it build a new balance around a new price.

In deciding all the questions requisite to formulating and executing a price policy, attitudes and temperaments loom large. Among numerous examples a few are cited to illustrate how far personalities can influence industrial welfare. In the rubber industry the dislike of two men for each other was a major factor in the price wars that took place. Each was determined to undercut the other no matter what the effect, and the entire industry had to follow suit. The carbon black industry is divided among three companies of approximately equal size. One has the reputation of being so set on proving its independence that it makes a practice of cutting prices at the least excuse. Suspicion is rife, secret rebates are rumored, special favors are whispered about and the worst is believed with the result that prices are cut, met, and cut again.

A leading china merchant in New York noted that a rival advertised a well-known brand at close to cost. "What a stupid fellow," he muttered to himself. "I know what he paid for it and I know that he is losing on every set he sells. But I'll show him. I'll punish him. I'll advertise that same set below cost." And he did. The frequent boast, "We meet every price regardless. Our organization can run at a loss as long as the next one," can easily be extended to, "We cut below every price regardless." By way of contrast, the coal business was long stabilized by the refusal of the head of

the Berwind-White Coal Mining Company to meet its competitors' reductions. So confident was he that others could not long afford to sell at prices below his that he sat tight and waited. Though he lost customers at first, after a time they invariably returned. For many years this company was a steady force. But eventually new factors came into the industry, bringing a new alignment.

The famous Gary dinners were an appeal to reason. Judge Elbert H. Gary, Chairman of the Board of the United States Steel Corporation, used to invite the heads of other companies to a series of dinners. At these he exhorted them to cooperate in maintaining the stability of the price structure. Although apparently no agreements were made, the price leadership of the Steel Corporation was followed and mutual understanding and confidence were affirmed. The ruthless extremes of price-cutting that had formerly characterized the steel industry were to some degree tempered.

Sir Alfred Mond's address at the First Annual Meeting of the Imperial Chemical Industries would have been pounced upon in the United States as proof positive of evil-doing:

The old idea of the heads of great businesses meeting each other with scowls and shaking each other's fists in each other's faces and . . . trying to destroy each other's business may be very good on the films, but it does not accord with any given facts. The alliance of great companies operating on huge scales with every kind of interest and working in harmonious cooperation renders it possible to have exchange of information as regards methods of business and new ideas, and we all do better by working in that manner.

The authors of *Cartels in Action* describe how peace is attained in the chemical industry:<sup>7</sup>

Adjustments of conflicting interests among chemical companies, as among sovereign states, is a ticklish problem. Political and commercial developments and technological changes are constantly shifting the balance of power. When a company's strategic position has improved, it ordinarily demands a greater share in world markets. Negotiations are often marked by bickering, bluffing, flexing of muscles, and caustic debate before a bargain is struck. A formal settlement, if and when reached, may be short-lived. Still, whether by enduring treaty or uneasy armistice, the leading "powers" have established a *modus vivendi*. They maintain it by periodic adjustment and renegotiation.

The major chemical companies adjust their affairs on the principle that bona fide competition does not pay. Occasionally independents, or even cartel members, may resort to the methods of industrial conflict. They may cut prices or duplicate productive facilities in a market admittedly not large enough to support additional capacity at existing prices. Or they may "invade" each other's sales territory. But such tactics are generally frowned upon as "unethical." They are more often threatened than practiced. When used, they are usually temporary expedients for obtaining a better bargain or bringing "rugged individualists" into line. They are preliminaries to diplomatic action, paving the way to a negotiated peace.

<sup>7</sup> Stocking and Watkins, *op. cit.*, p. 421.

In almost every industry there is a bad actor who is always ready to play for a technical advantage, even to unleash his destructive power. There are also some so short-sighted in extracting an added profit at every opportunity that they encourage new outside competition. Their machinations at times defeat the plans of the wiser and more experienced leaders in the industry and make them seem reactionary and out of date. The way in which a new process or invention is introduced may strengthen the industry causing little loss, or it may bring widespread damage unnecessarily. It is difficult to estimate correctly the relative effects of these stabilizing, progressive, and destructive forces.

Despite the apparent chaos, the methods of managerial enterprise are fairly successful most of the time. Commerce somehow goes on, articles change hands and prices keep on a more or less even keel. Administrators vary in their ability to analyze the contradictory forces affecting demand, as well as in their self-confidence and their willingness to take chances. Some will keep their eyes glued to the records and hesitate while others will rely on their intuition. Most manufacturing concerns make such a small variety of articles that the price of each is of great consequence. Occasional meetings are held in which all executives concerned take a part. Other concerns making a greater variety of products have adopted a formula for figuring costs which is deemed to reflect their general policies. Distributors handling an even wider variety of articles also have general policies, administered by the appropriate executive.

However variously they may be arrived at, costs tend to establish a lower limit for prices. The fear of losing sales and of not achieving the minimum quota of a profitable volume

exercises a downward pressure on prices. So far as price is a contributing factor in public demand, it must be at a level that facilitates sales. If sales fall short, surplus stocks pile up and the proportion of overhead to be charged against each sale then mounts. Again the hope of exceeding allotted sales is a spur to lower prices. Contrariwise, if the price is placed so high as to stifle sales, costs rise to such an extent that no price can be high enough to cover them. Thus the strength of the downward pressure on prices varies with the factors governing demand. When demand is constant, reducing the price is of no avail, but on the other hand, when a lower price uncovers a new source of demand, the volume may be so increased that then the costs of production can be reduced.

Administered prices cannot be regarded as scientific, if this means that it can be demonstrated that they are the most effective to dispose of a given quantity of goods. Price administrators are always being surprised. Sometimes they do better than they expected and other times worse. Modifying policy to meet the exigencies of the market is the daily business of management. But the inauguration of a new policy is a matter of profound gravity.

Any attempt to maximize prices in accord with the monopoly theory is practically impossible. The sequence is rather that policies are formulated in the light of experience and prices are then set by the application of these policies. It would be a rare chance and difficult to prove, that a price so set maximized profits. Demand and price do not always move inversely to each other. Each is subject to many different conditions as well as to the same conditions. Experiments are conducted to isolate and analyze effects of price

changes. The articles a person buys express his manner of living and his scale of values. The demand for individual articles is part of a society's consumption pattern. If it is altered there is a series of compensating adjustments. These changes in consumption which are subtle yet potent play continuously on the demand for different articles.

Of necessity administered prices are more rigid than the market place and auction prices of free enterprise. They are named in the hope that they will remain stable over as long a period as possible. Administrators weigh the impact of various policies. The ten questions discussed at the outset of this chapter indicate the problems administrators face in naming a price. At one time, they stress stability; at another, the possibilities of capturing an expanding market; again the need of covering costs when demand is declining; still again, the strength of direct competitors or the chances that they will lose out to more remote competitors. Out of this welter of circumstances, potentialities and policies, prices emerge. Their rightness or wrongness from the point of view of the company or of the national economy cannot be judged by any single standard. Any such judgment must take into consideration the complex of circumstances, potentialities, and policies that confronted the price administrators.

## Profits—An Elusive Concept

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IN THE THEORY of free enterprise the concept of profits is settled and stable. Profits can be allocated to either transactions or periods. To some extent, they are the inverse of costs, which can also be measured and verified. With the growth of managerial enterprise, the measurement of costs has become involved and the concept of profits elusive. Indeed it may be said that the profit of an enterprise can be determined only when it is finally wound up. Until then it is a matter of estimate, resting upon many accounting conventions and controlled guesses which imply rates of obsolescence and depreciation, the allocation to periods of all kinds of expenditures including those for experiments, the setting aside of reserves, and the valuation of current and fixed assets. In retrospect profits can be measured with a fair degree of accuracy. But current statements, dependent as they are on forecasts, are dubious guides for investors. Perhaps a five- or ten-year estimate might give a reliable picture though this raises still other problems. The customary one-year statement is problematical, and the semi-

annual and quarterly statements have little validity of any sort.

Take for example a seasonal industry. The autumn volume is commonly about 50 per cent higher than the spring volume. If rent, depreciation, and other fixed expenses are divided into twelve equal parts, monthly expenses will be quite different than if they are allocated on the basis of expected sales. Yet rent, instead of being a fixed sum, is at times a percentage of the volume of sales.

Again take the appraisal of inventory. No matter how carefully the method has been worked out or the partial costs of unfinished products have been computed, and the process of stock-taking perfected, the value depends upon a judgment as to its future salability. Reserves to cover its depreciation may be too large or too small. Mindful of their experience after World War I, businessmen set aside huge reserves during World War II. If the depreciation on their stocks turns out to be less than they fear and they write the excess reserves back into earnings, then the profits of the later period will be swelled and the chances increased that earnings will be allocated to the wrong period.

Should expected losses not be written off until their exact amount has been ascertained? If they are not, they will be allocated in their entirety to the last period of the year. Or should they be estimated roughly and charged against each period? Either method is theoretically defensible, but the distribution of costs will of course vary with the method adopted.

Take finally the computing of income taxes. Though the total tax for the year cannot be known until the end of the fiscal period, amounts to cover it must be allocated to each

accounting period. Hence the allocation for each period is a stab in the dark, especially when tax rates have not been in effect long enough for precedents to build up.

The arbitrary aspect of the decisions on which semi-annual statements of profit are computed is accentuated in quarterly reporting. Only if the history of the period and the bookkeeping methods are intimately known can an approximate understanding of the company's position be gained. Yet the public is being educated to take quarterly reports more and more seriously. A cost accountant of wide experience is alarmed over the possibilities of misinterpretation:<sup>1</sup>

The question, as I see it, is not one of the use, or utility, of present-day statements but rather one of avoiding, if we can, the misuse of such statements by those who are not so well informed as the management or the independent public accountant who examines the statements.

Profits estimated by an equally logical or illogical theory will vary widely as between periods. So far as general conditions remain fairly stable and accounting methods are not changed, valid comparisons can be made, more readily in some industries such as utilities and railroads than in manufacturing or distribution. But violent fluctuation has been a feature of the last few decades. Consequently there comes a point at which it is a fine question of judgment whether a constant method under different conditions makes for greater error than a shift to a method designed to reflect the

<sup>1</sup> Jennings, Alvin P., "The Tentative Nature of Financial Statements under Present Conditions," in *Lybrand, Ross Bros. & Montgomery Journal*, Jan. 1944, p. 10.

changes. Unhappily there is no divining rod for the ascertainment of this point. It can be found only by examining the facts. It also calls for interpretations of expert opinion. And expert opinions can and they do differ.

Until recently judgments tended to err on the downward side in estimating profits. This is the corollary of erring on the upward side in estimating costs. It was considered sound practice to charge depreciation rates at a maximum, to set aside large reserves for contingencies, and to choose the lowest possible basis for valuing inventory. This has led to the growth of so-called hidden reserves. In some cases these were supposed to be so enormous as to affect market values, and this partly nullified the very object they were intended to effect. Another way to amass reserves is to leave earnings in the subsidiary companies. Thereby surpluses are accumulated, to be drawn on by the parent company in the form of dividends when earnings fall off. One company has varied the dividend-earnings ratio of its subsidiaries from one-third to one and a half, thereby helping to stabilize its reported profits.

For the purpose of estimating the market value of a company, it is natural to capitalize profits rather than to use book figures. The rationalization involved in this lies in the assumption that the rate of profit will be maintained. But such a procedure is vitiated if profits are continuously understated by reason of the excessive rate at which depreciation has been charged. Book values will then be cumulatively understated. The discount rate at which reported profits of different concerns are capitalized varies as the accounting formulas are believed to have led to an over- or an underestimate. In a period of reduced earnings, however,

the profit rate can be stabilized only by altering the methods of bookkeeping, that is, charging less than usual to depreciation, obsolescence, and reserves of various kinds. Such a lack of uniformity can be justified on the ground that reserves are already ample and need not be augmented further. This may well be true in so far as there is any abstract standard of truth. But the issue is whether the rate of profit announced is steadier than it would have been had such charges been at a fixed rate.

Into the complexities caused by the elusiveness of profits enters the Treasury Department. It is commissioned with the duty of collecting taxes based on profit and is armed with the power to examine the methods and practices on which profits are calculated. In its zeal to collect a large revenue it has undermined the ethics of the business officials and the accountants whose duty it is to estimate and announce profits. Instead of being praised for their conservatism and judgment, they are suddenly accused of understating profits to evade taxes. They had to reduce rates of depreciation, which at best are merely informed guesses, and capitalize and spread over several succeeding years expenses that had been charged to current operations. Maintenance and improvement of property are so much a matter of judgment that expenditures can be classified only roughly. Repairs to a building or machine may merely restore its value, but they may also enhance its value.

The Treasury has now been actively interested in maximizing the annual announced profit for more than a decade. In consequence it has tended to diminish profits in ensuing years. Until 1945 the rate of taxes on profits was progres-

sively raised, at first slowly and then at an accelerated pace. The corollary has thus been that by forcing upward the estimate of profits in the early years, the Treasury rulings have deprived the government of high taxes on high profits in the later years. The extent of this loss has not been and perhaps cannot be calculated. But observations indicate that it is considerable.

The insistence of the Treasury that companies defer charges, thereby swelling estimated current profits, has frequently been considered by business officials and accountants to go so much further than is warranted as to mislead the public. Companies do not dare publish the figures of earnings on which they pay taxes. Within limits of course, differences in calculations may be admitted, for there can be no precision in estimates of the depreciation rate. Beyond a certain point however, the traditions of conservatism that underlay published statements could not be violated. As a result a double set of bookkeeping figures has developed—often in the form of memos—one reflecting Treasury estimates and used for tax purposes and the other reflecting business judgments and published. These two tend to diverge more and more as the years go by and the disparity between the two totals cumulates.

The influence the Securities and Exchange Commission has had on estimates of profits is less obvious. In general it has accepted the statements of accountants whose training inclines them to underestimate. In addition it has shown a strong tendency, which might be called a policy, to insist upon writing off capital assets. This has contradictory consequences. For once assets have been written off, the ratio of profits to capital is higher. On the other hand as far as

the write-offs are taken out of profits, the latter become smaller. And these effects may be more than temporary. They may last several years.

In the case of public utilities, the pressure to reduce the book value of capital assets gives the regulating commissions an instrument for lowering rates when earnings seem out of proportion. It is sometimes argued that all values beyond physical investment are created by the community and that therefore the community should not be charged to maintain values it has itself created. In cases other than public utilities book values are reduced through writing off intangible assets, especially good will. The solid reason on which this policy rests is that good will is not permanent and may evaporate. On the other hand of course, it may increase.

If assets are written down drastically the surplus is at times converted into a deficit. Since dividends can be paid only from surplus they must be passed until the deficit is wiped out and a surplus restored. Even dividends on conservative preferred shares with adequate earnings are passed. Such radical changes lead to compromises which spread the effects over a long period, but meanwhile the amount available for dividends is reduced.

The final statement of earnings is a compromise arrived at after endless discussion of the diverse viewpoints of business officials, public accountants, Treasury officials, and the Securities and Exchange Commission. It satisfies no one. And it is of little help to the outsider who has not participated in the discussions and can therefore have no knowledge of the details. Any judgment concerning the nature and permanence of the forces that tend to drive the re-

ported earnings up or down requires a highly technical analysis of facts not ordinarily at the disposal of the public.

Nor do profits have any invariable relation to efficiency. The industrial structure changes so rapidly that a strategic advantage of one year becomes an incubus the next. Once capital has been sunk, it is retrievable or useful for some other purpose only in part, if at all. Obsolescence often antedates deterioration. In many situations, local, industry-wide, or intra-corporate, any immediate hope of profit is futile.

Everyone is acquainted with small businesses that never have a chance. Machine shops, service industries, and stores are constantly finding that the cards are stacked against them and fold up. At the other end of the scale entire industries may be profitless for many years at a stretch. Notable among these was the rubber industry, despite the vast demand for its products and the acknowledged excellence of its management. Ralph Epstein, in his *Industrial Profits in the United States*, found that the meat-packing industry was operated during the decade covered by his study at a uniformly low rate of profit. But there is a joker in comparisons of rates of profit between industries. The rate depends upon the valuation of the capital, a book figure built up over many years according to individual policies and formulas. Different industries and companies within an industry have customs and practices of their own. The pedestals of profits and capital values upon which the rate stands are not as solid as they appear nor are they comparable in their structure.

Catastrophic are the situations where a concern is largely dependent on one customer and that customer de-

cides to buy from another source. Though temporarily profitable and in certain industries not infrequent, such dependence is unsound. If a supplier of automobile parts—wheels, tires, spark plugs, bearings, or bodies—sells his entire output to one company he is at its mercy. Similarly a manufacturer whose sole customer is a mail-order house may lose his entire business by one cancellation. There is the case of a stamper of fork and spoon forms for silver plating who went bankrupt when the silver company to which he had sold exclusively put up its own stamping plant. All efforts to find another outlet proved unavailing.

The fact that fluctuations in profits plague intra-corporate divisions is not so generally recognized. In retail merchandising, for instance, certain departments, such as house furnishings, glassware, drugs, sheets, pillow cases, towels and house dresses, almost never yield any profit. Certain other departments, such as silk goods, upholstery, hosiery and jewelry, are equally notorious for their high profits. To be sure a large number are either profitable or not, depending upon the management. And certain articles, such as cigarettes and sugar, are always profitless.

Variations in profits have no more inevitable relation to accounting than to efficiency. The reason that profits vary is because accounting must, as far as is feasible, adopt definite rules and these cannot be adjusted to fit the niceties of dissimilar situations. Were costs distributed arbitrarily so as to indicate an even flow of profits, there would be no point in comparing the profits of different divisions. More likely, reasons for persistent variations are in part due to tradition and in part to the diverse nature of the merchandise handled. A drug or variety chain store is organized to

handle articles of small value whereas a jewelry or rug or furniture store is equipped to deal in expensive articles. But a department store or mail-order house deals in both, and everything in between. Yet it must use a single method of accounting. No one method can be well adapted to all. Moreover profitless departments cannot be dropped without forfeiting trade position, and this may be more serious than carrying them at a loss.

Habituated under nineteenth-century free enterprise to distribute substantially all profits in the form of dividends, the owner-managers of the early corporations paid an interim dividend around the middle of the year and then a final dividend. The amounts depended on the earnings of the year and the needs and opportunities for expansion. With the growing complexity of the corporate structure there arose the practice of retaining some part of the earnings in the business. "A dollar for surplus against every dollar for dividends" became the roundly applauded slogan of the Pennsylvania Railroad. Bonds came to have indentures limiting the payment of dividends, and indebtedness was retired out of earnings. The governing policy of this financial practice was to safeguard senior investments. Profits and dividends began taking divergent courses.

The further separation of ownership from management brought the philosophy that dividends must be paid at a regular rate in bad years as well as good, even though that rate might be lower than average earnings. While dividends could not be counted on with the same certainty as interest and wages, this ideal might be approached. After all, neither interest payments nor the job itself nor wage rates are completely secure. Today a few corporations can boast that

they have paid dividends during each year for over a generation. The stockholder looks upon his holdings as a source of income and wants to be sure of his dividends. He would like them to be substantial but he prefers a regular quarterly check to variations. A considerable fraction of stockholders are women. Another large fraction are retired men. And no small proportion are educational and philanthropic institutions. Their fixed expenses require a fixed income.

Latterly high income-tax rates have had a disruptive influence on the payment of dividends. Calculations show that in corporations dominated by a family or small group, savings are better preserved when reinvested in the business than when distributed to individuals in the form of dividends. The reason for this is the Treasury's arbitrary definition of income which stresses its conversion into cash rather than its accrual. Dividends are subject to taxes which are avoided when earnings are retained in the corporation. To plug such loopholes, Congress and the Treasury Department have evolved a series of highly technical laws and rulings. These rules have caused the substitution for policies based upon sound business judgment of policies controlled by tax considerations. Apparently there is no real solution to the problem. It must remain a game of hide and seek. Or perhaps rather blind-man's buff.

Just when the ideal of a fixed and relatively secure dividend rate seemed to have been realized, the tumultuous thirties rendered its achievement patently impossible. Even the most solidly grounded organizations bowed before the storm. The American Telephone and Telegraph Company was among the few that held stubbornly to its established rate despite insufficient earnings. Owing to the wide distri-

bution of its shares in minute holdings among individuals dependent on the dividends, its directors felt a peculiar obligation to pay as long as possible.

By and large the uncertainty of the times has put a crimp in the evolving trends of managerial enterprise. Stockholders tend to be thrown back into the position of residuary risk capitalists. Forecasting becomes precarious. Extra year-end dividends based upon past profit are more and more common. These of course vary. Nevertheless the ideal of continuity and stability as preferable to variability remains, and a resumption or increase of dividends is seldom approved unless the future offers more than a fair prospect of its maintenance. Few directors have a personal interest in the dividend rate. They would rather vote for the same rate than declare a higher dividend and then have to run the risk of explaining a subsequent reduction. The occasional directors who have substantial holdings have found that any increased income they received was eaten up by taxes. These influences, together with the uncertain costs of post-war reconversion, have combined to lift reserves against contingencies to peak levels.

Ploughed back earnings affect much besides future dividends. They strengthen the position of senior security holders and employees. These interests will then resist a later distribution. The stockholders may never share the surplus which is often used to reduce debt or start a pension fund. So far as this tendency becomes solidified in practice, it emphasizes the shift of the stockholder from an owner to a claimant of income.

Under the best of circumstances, short-term profits are elusive. At present, with circumstances at their worst, an

estimate can be nothing more than an informed guess. Unfortunately, printed balance sheets, which are itemized to the last penny, look so exact as to gloss over the arbitrary assumptions inherent in any estimate. This precision is misleading and it may cause many errors of overconfidence.

As has been argued, so far as dividends are a regular payment they may be regarded as an expense on a par with other expenses. Should this concept be carried to its logical conclusion profits as such would disappear. They would be replaced below the line by a surplus or a deficit and this would be added to or subtracted from the figure carried forward from the preceding year. The increase or decrease of the surplus would be evidence of the strengthening or weakening of the business as a whole. It would indicate the degree of assurance with which all participants might regard the stability of their share of income.

Practically there are four claimants to this surplus. They are the government through income taxes, management through bonus arrangements, employees through benefits and incentive wages, and stockholders through extra dividends. The management occupies the hot and uneasy seat of being at once participant and dispenser. The channels of their distribution are the subject of the next chapter.

## CHAPTER

# 9

## Allocation and Division of Income

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THE POWER THAT management has in guiding and determining the distribution of income derives from the importance of managerial enterprise in the economy. This distribution is not affected by the impersonal market as it is under free enterprise. In large degree it is discretionary and is governed by long-run considerations of prudence and policies. The gross income of the organization is the fixed point of departure. This is what there is to distribute. In its apportionment among the various claimants, management plays the dominant role. Sometimes voluntarily and at other times under pressure, it negotiates and decides. Its own share is at stake along with those of other claimants but this is relatively small and does not materially affect the total picture. The gross income is apportioned among six categories which comprise:

Supplies of either raw materials or semi-finished products.

Taxes.

Maintenance and upkeep in their broadest sense.

Wages and salaries.

Returns to capital.

Surplus added to or deficit subtracted from the corpus.

With the exception of taxes, these allocations are partially fixed and in part are subject to a discretionary allotment. Each of the first five requires a certain minimum of expenditure. And the margin by which gross income exceeds the sum of these minima offers the opportunity for the play of imagination and of pressures. The narrower the margin, the less the leeway for constructive policies on the part of management and the more it can resist pressure. On the other hand the wider the margin, the easier it is for management to carry out its social obligations and strengthen its trade position but then it is subject to greater pressure from all claimants. In line with the argument of the preceding chapter, dividends are regarded as a discretionary distribution of return to capital, in the sense that higher than minimum expenditures on maintenance and wages are discretionary. To classify dividends as a regular expense is not in accord with present accounting practice. This practice reflects the conditions of free enterprise when the owner-manager drove a hard bargain with everyone and kept what was left over as profits. In such circumstances profits were correctly considered a surplus from which dividends were paid. As will be recalled, the early family corporation, in the spirit of free enterprise, paid year-end dividends of varying amounts depending on profits and the opportunities for expansion.

The supplies purchased from outsiders such as raw material and unfinished part adjuncts in the case of manufac-

turers, or articles of merchandise in the case of distributors, are determined by the sheer necessities of business. In the terms of sale, however, there is at times scope for negotiation and choice. In free enterprise each deal is a separate transaction. In managerial enterprise, on the contrary, continuous relations between buyer and seller are required. In the case of a single purchase a close bargain is struck. But when future transactions enter into the picture, it is bad policy to take advantage of a temporary situation and crowd a valuable resource to the wall. Statesmanship has a place in business no less than in politics, even to the point of paying a higher than necessary price or advancing a loan.

It is wise policy to have available several sources of supply for every important item purchased. Thereby too great dependence on any one source is avoided. Also old relations are often so advantageous in facilitating day-to-day operations that the long-run savings more than offset any added charges made for single items. The possible savings that might result from changing suppliers would be dearly bought.

Taxes are fixed by law, in part at constant rates and in part through their relation to net income. So far as income taxes are concerned, they have all the arbitrariness that attaches to the computation of net income. This peculiarity of accounting thus makes the amount of this expense dependent upon the residuum which is a subject to be probed further when we discuss returns to capital. The point to be noted here is that government is in exactly the same posi-

tion as any other claimant of net income. The share of each depends upon the success of the concern. Broadly speaking, management can do little about taxes beyond adjusting its accounting system and decisions to the technicalities of the law. There is nothing voluntary about paying taxes.

Maintenance, which is the amount spent on keeping plant and equipment in shape, is a vague term denoting equivalence of value at the beginning and the end of a period. There may be, of course, either improvement or deterioration. Such things are measurable only roughly and this opens a wide field for judgment. Maintenance has to do not merely with the plant itself, but also with employee relations, public good will, holding the position in the trade by the development of new markets and new products—everything that contributes to effective functioning. Depreciation is the fund laid aside to offset losses of value through daily wear and tear, for despite all upkeep, equipment depreciates. Its life can be estimated and by the time it has to be replaced, its cost will have been written off. The rate of depreciation varies with the estimated number of years of expected service, at the end of which period cost of maintenance will have arrived at a point where it would be greater than the cost of replacement.

Obsolescence is the sudden destruction of value or utility through any change, a new method, or a new invention. This concept can be extended to include elements outside the organization. There is less opportunity for judgment here than in the determination of maintenance. When a new machine is much cheaper to run than an old one, its original cost, though high, can be paid for out of the savings

effected on the servicing and operation of the old one. Machines also become obsolete through the introduction of new methods just as locations become obsolete through improvements in the means of transportation and the construction of new highways. A busy community may become a ghost town. Analogous too are the changes that destroy a market carefully built up during years of effort. Such obsolescence occurs through wars, revolutions, technical inventions, or changes in method. An international organization has a steady stream of such losses. Pertinent is David A. Wells's description in *Recent Economic Changes* of the vast extent of obsolescence in shipping and warehousing caused by the opening of the Suez Canal.<sup>1</sup>

Before that time, and since the discovery by Vasco da Gama, in 1498, of the route to India by the Cape of Good Hope, all the trade of the Western hemispheres with the Indies and the East toiled slowly and uncertainly around the Cape, at an expenditure in time of from six to eight months for the round voyage. The contingencies attendant upon such lengthened voyages and service, as the possible interruption of commerce by war, or failure of crops in remote countries, which could not easily be anticipated, required that vast stores of Indian and Chinese products should be always kept on hand at the one spot in Europe where the consumers of such commodities could speedily supply themselves with any article they required; and that spot, by reason of geographical position and commercial advantage, was England. Out of this condition

<sup>1</sup> Wells, David A., *Recent Economic Changes* (Longmans, Green, 1890), pp. 29-30.

of affairs came naturally a vast system of warehousing *in* and distribution *from* England, and of British banking and exchange. Then came the opening of the canal. What were the results? The old transportation had been performed by ships, mainly sailing-vessels, fitted to go round the Cape, and, as such ships were not adapted to the Suez Canal, an amount of tonnage, estimated by some authorities as high as two million tons, and representing an immense amount of wealth, was virtually destroyed.

Another form of obsolescence affects an entire industry. Rice ceased to be cultivated in the flat marshes of the Carolinas when growers discovered that by drying out the higher ground of Arkansas, Texas, Louisiana, and California they could mechanize cultivation. So likewise the mining of rock sulphur was given up when the product could more easily be brought to the surface through the steam process in Texas. In popular lines silk seems on the verge of becoming obsolete, as industry adjusts itself to rayon and nylon. Such startling changes may wipe out the accumulated capital savings of years.

Reserves are entirely a matter of prudence, set aside to provide for those unpredictable and incalculable incidents that may have to be borne in the future. Consequently in retrospect alone can they be proved too small or too large. If adequate, they nullify the effect of the damage when it does occur. Reserves to offset probable loss properly belong to the period in which the loss occurs and in effect they merely shift expense from one accounting period to another. Experience has shown that normally an inventory brings in

less than its market value when it was taken. In this case the expected loss should be charged against the preceding period rather than carried over to the next. Reserves may also be set up against replacements which, though unnecessary at the moment, are foreseeable, or against pension payments not yet due.

Beyond the minimum, management is under no pressure to spend more on maintenance or set aside more for the future than it sees fit. The amounts vary directly with chance, success, and judgment. But once spent or set aside, these sums are removed from the grasp of other claimants.

Turning now to salaries and wages the distinguishing characteristic of salaries is that they are fixed for a period, say a year or a month. Wages however are fixed by rates—for the piece, the week, the day, or the hour. From the viewpoint of distribution they stand on the same ground, for both are earnings of employees. In considering wages and salaries, management is concerned not only with the rates themselves but with the proportion they bear to total expenses and to gross income and their effect upon costs. From this viewpoint of management the rates per se are subsidiary. To the individual employee, on the contrary, his rate is all important for it determines his individual earnings. It is in the reconciliation of these two viewpoints that much controversy arises.

This change in attitude on the part of management reflects the great shift from owner-entrepreneur and employee negotiation to management and employee negotiation. Management apart as it is from ownership represents the organization as a whole, its place in industry and its future, rather than the stockholder exclusively. It has obli-

gations to stockholders, but not solely as their representative. Rather it must see that their claims to a fair share of gross income are met.

Management looks upon salaries as a means of building up a corps of elite personnel that will carry on its essential policies. Each member acquires specialized knowledge that might be sacrificed were he to leave the organization. His value to it is disproportionately large in comparison with his market value. Specialized knowledge may be crucial as in the case of key officials, or it may be merely convenient as in the case of lesser officials, foremen, and other strategic personnel. The objective of management is to assure continuous functioning and the amount paid in salaries is a small part of total expense. It is natural, therefore, that salaries should be named for a long period and should be on the liberal side. Objections to high salaries are raised mainly by stockholders when dividends are not forthcoming.

The proportion that goes to the wage-earning employees is in a quite different category. Generally wage payments are a large proportion of gross income, in many industries from 50 to 70 per cent. Inheriting the attitude of owner-entrepreneurs, management at first regarded wages as an expense to be minimized. While the last twenty-five years have modified this original attitude of management, survivals still persist. Only recently and in a few instances has management come to see itself as the independent agent of the entire enterprise, with responsibility to employees. Above the necessary minimum therefore, the wages which management pays are determined largely by its ability. There is much evidence to indicate that within an industry successful concerns pay higher wages than unsuccessful.

Certain it is that some concerns with a traditional low wage policy found themselves with a diminishing labor force amid the stringencies of war production.

So far as management feels any personal pull, its sympathy is likely to center on the welfare of two groups of its employees. These are those who have been with the company for many years and those who seem to manifest special promise. The future welfare of the enterprise depends upon the latter and there are seldom enough of them. The former are giving their lives to the organization. Their claim is very real. Management sees them daily, knows their histories, their home problems, their illnesses, their efforts, and their weaknesses. Much of the satisfaction management derives from its tasks lies in watching these people build satisfactory lives for themselves. Hence twenty-five-year and fifty-year clubs, pensions, sickness benefits, classes, and the like have become more and more common.

Directors, whose relations with the enterprise are impersonal, feel more kinship with the stockholders. They seldom visit the plant, never see an employee as an individual, and are apt to miss the drama. Engrossed as they are with their own affairs, they concentrate their attention on the balance sheet and statement of profits, and fail to inquire or feel any responsibility for what lies behind the figures. It takes special effort, imagination and a desire to probe beneath the surface to sense the living struggle, the disinterested loyalty, the close decisions, and the anxieties of human beings that make the balance sheet what it is.

Management can take a professional satisfaction in being able to pay high wage rates. But it has obligations to other portions of the organization too and above all to the enter-

prise as a whole—its strengthening and perpetuation. High rates of wages are in one sense an advance claim against the surplus which it is hoped will accrue.

The proper yardstick for wages is a correct judgment of ability to continue to pay the same rate. Fearing that the setting of high hourly rates based on the successful performance of a past year may establish a precedent that could not be followed under normal or depressed business conditions, management is reluctant to make a commitment. Rates once fixed are not easy to lower. Morale is shaken by a cut in piece rates. Those who have had to administer any wage reduction will testify to the difficulties.

The hard-knocks managers have experienced in achieving their position inculcate habits that often give rise to prejudices. No doubt sensitivity is not a helpful quality on the tough road to success. Even when there is desire to meet demands, it is tempered by uncertainty about the future. It is always easier to break a rule and mend a present situation than to stick to a policy. Few have the imagination to foresee where patching up for the sake of expediency will lead.

The next to last category of the allocation of gross income consists in returns to capital. This is made up of three parts—rents, interest to bondholders, mortgage holders, or banks, and finally dividends to stockholders. Each has a proper and necessary claim to a portion of gross income but accounting convention and legalism put interest and rent into one category as an expense on a parity with wages and maintenance and treat dividends as a distribution from the surplus. This method of accounting reflects the theory of an owner-manager enterprise, but not that of a managerial en-

terprise, in which in the light of reality the stockholder is a claimant of some portion of gross income, subject to the judgment of management.

Interest is the contract payment for borrowed money. Rent is the payment for equipment that is hired. A rent contract is usually entered into for a long period. The rate may be fixed, adjusted by agreement or arbitration every few years, or varied on a prearranged scale or according to a formula that reflects the success of a concern. In the last case, the owner of the property is on a par with other claimants.

Because management is concerned with the enterprise as a whole, the welfare of any component must be sacrificed when necessary. The easiest to sacrifice is the stockholder. Some portion of the return to capital is, however, regarded as in the same category as the other expenses of the enterprise. The appropriate rate of dividend may be decided on various premises. Perhaps it may be the customary rate or an amount sufficient to attract new money when needed, or an estimated percentage of invested capital. However decided, the resulting amount is arbitrary being based upon formula and judgment. And it is in this respect that it is in the same category as the other expenses of the enterprise where judgment is decisive.

As a claimant to income, the stockholder is in an uncomfortable position. He may no longer with accuracy be regarded as the residuary owner, for the surplus ordinarily reverts to the enterprise as a whole. Even more equivocal is the position of the preferred stockholder. Technically he is paid out of profit, albeit he is a claimant to a fixed amount almost on a par with the bondholder. Technically, but not

in fact, is he distinguishable. Interest on income bonds emphasizes this confusion. For it too is paid only when earned, yet is entered as an expense on the books.

This position of the stockholder as claimant is not as clear as it is described. It is more precisely in a twilight zone. Dividend rates are changed and extra payments are made, but with due regard to the need for conserving assets. No dividend is paid if it might endanger stability. The stockholder can put little pressure on management, which he is practically helpless to influence. He cannot go on strike. He can only voice a feeble protest and vent his feelings in sarcasm at the annual meeting, for whatever that may be worth.

After all expenses have been covered, the surplus or deficit is absorbed by the concern as a whole. In accounting terms it is added to or taken from "earned surplus," the item from which dividends are paid. Whether the surplus increased or shrank during the particular accounting period, dividends can be paid, as long as there is any such surplus. Paying dividends out of surplus is a purely legal device intended to protect the original capital investment. With the passage of time this legal device is ceasing to some extent to serve its purpose. The process has been hastened in many cases by the writing down of the par value of stock thereby increasing the surplus arbitrarily. So meaningless has the original figure become that no stigma seems to attach to what would otherwise seem an accounting trick intended only to deceive. On the contrary, the device is used quite openly and honestly.

Capital values may be written down for other purposes.

Great efforts have been made in recent years by public service commissions and the Securities and Exchange Commission to write down capital values. In the case of public utilities, the object is to establish a smaller capital base thereby warranting the ordering of lower rates. Without entering into the question of the justness of this policy, it is to be noted that the effect has been to render illegal the payment of dividends that have been earned according to short-term accounting standards, because the "earned surplus" has been wiped out, or even turned into a deficit. Before any more dividends can be paid, a new surplus, either through the accumulation of earnings or through accounting adjustments, must be created.

When an old concern seeks new money, the lender will appraise its assets at their present rather than at their book value. If the present is less than the book value, he then demands special protection, such as collateral or a lien on property or accounts receivable. He may stipulate that no dividends be declared until the loan is wholly or partly liquidated, or again that a certain amortization be paid each year. While the arbitrariness of accounting may be admitted, it is difficult to see how a concern can do other than carry its capital assets at a fixed figure. The concepts of invested capital and of income during a definite period are fundamentally incompatible. Capital value can be estimated at any time and sanctified by a sale. But income can be approximated only by the fiction of a fixed capital at the beginning and end of a period. For any purpose of valuation, the concept of either capital or income must be sacrificed, dependent upon the objective. Accounting practice

concentrates on an estimate of past earnings whereas the sale of capital assets disregards past earnings, and attempts to estimate future earnings.

Not all concerns have a surplus after the payment of expenses, even before dividends. In the twenties corporations having a deficit comprised nearly 40 per cent of the total number of companies. This ratio increased to around 70 and 80 per cent in the early thirties, dropping back to 50 and 60 per cent in the later years of the decade. Such statements of losses may not show the efficiency or success of any enterprise. What they do show is the distribution of gross income among the various claimants.

Depending on the margin between gross income and the necessary and desirable expenses, which is usually regarded as the measure of success, the order of priority of expenditures is somewhat as follows:

**Necessary minimum expenses**

Purchase of supplies

Local taxes

Minimum wages and salaries for essential employees

Minimum maintenance and upkeep

Interest on debt

Minimum rent

**Desirable expenses**

Extra payments to ensure a continuous flow of supplies

Wages and salaries at full market rates

Satisfactory maintenance

Minimum dividends

Income taxes

Higher rent

Utopian expenses

High wages, including vacation allowances, pensions, and benefits

Salary bonuses

Promotional maintenance, research, expansion

Generous dividends with probable continuation

High income taxes

Reserves for future mischances

Funds to strengthen the trade position

The distribution of a minimum income is easy but unpleasant. There is no room for choice. Every claim must be whittled down. Such a situation cannot last long. The firm either decays into bankruptcy or merger or is saved from the gutter by the taking of an unwarranted risk. Gross income must be increased if there is ever to be enough to distribute. In short, goods must be produced before they can be sold. In other words inventory must be purchased, operating efficiency stepped up, and wages and salaries raised to make willing workers. Management must somehow finance these expenditures, and apportion them carefully where they will do the most good. No concern can remain in business long unless it is in a position to incur desirable expenses. At this stage the stockholder is neglected in the distribution, for the risky experiments have not yet been vindicated. All expenses must be anxiously scrutinized until continuity seems reasonably assured. Expenses incurred in the hope of stimulating demand are a burden until they are justified by sales and gross income.

Most businesses never go beyond this stage. Reserves are dissipated in unexpected losses as fast as they are set aside. Results do not quite come up to hopes. As one farmer inquired of another: "How are your crops, Cy?" and Cy replied: "They're not as good as I expected them to be, but I didn't expect them to be."

Occasionally however, Utopia arrives even though it be short-lived. Experiments have not only been vindicated but have paid for themselves. A strong trade position has been attained. Reserves are ample. There is a surplus to distribute. At this stage management may change its attitude. There is no longer a question of to be or not to be. Now the questions are: How shall expenditures on maintenance, higher wages and salaries, and dividends be apportioned? Can prices be lowered?

An excerpt from a letter to stockholders written by the President of the Corn Products Refining Company under date of January 24, 1947, illustrates the apportionment when there is something to distribute:

In the period, corn became available and at declining prices. Demand for our products continued at a high level and increased production was possible following the rescinding as of October 16, 1946 of War Food Order #145. These favorable developments resulted in improved earnings and enabled us to pass along benefits to customers, employees, and stockholders.

Our selling prices of bulk products have been reduced several times in the last three months in keeping with lower corn prices and also because we wish to see

the existing high cost of living reduced. Furthermore, we want to keep ourselves and our customers from being priced out of desirable volume markets.

A wage increase of 10¢ per hour was voluntarily offered to the hourly employees, effective November 1, 1946, and accepted with appreciation. Compensating adjustments in remuneration were made to the salaried staff.

At the Directors' meeting on December 24, 1946, the regular dividend on the Preferred Stock was declared, and the quarterly rate of dividend on the Common Stock was increased from 65 cents to its former rate of 75 cents per share.

Professional zeal drives management to open new markets and try improved techniques rather than to give bigger allotments to claimants. The letter quoted above goes on to say that a new factory is being built.

Trained in the school of adversity, management is ill-equipped to cope with the problems of Utopia. It is reluctant to undertake new commitments that later events may render impossible of fulfilment. Always confronted with the future, it hesitates to create liabilities that may become precedents. What is a justified expense today may be an oppressive one tomorrow. Employees accustomed to high rates of wages and salaries and stockholders to a given dividend are resentful and suspicious if any reductions are attempted. Reserves and still greater reserves are the sole safeguard against the expected misfortunes of the morrow. The urge to get into a strong position presses. It is difficult for management to persuade itself that in a world of change, Utopia too will not succumb.

# *PART THREE*

## THE EFFECTS

### CHAPTER 10

## Monopoly Reconsidered

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THE CLASSICAL concept of monopoly is simple. As the word implies, it is oneness—the exclusive possession of the trade in some commodity. The classic example was the salt monopoly. In the sixteenth and seventeenth centuries a monopoly of an article in a given area was granted as a favor by the sovereign. The right of exploitation went with this grant, and the lengths to which it was carried aroused hatreds that have survived in our own time. In the nineteenth century monopoly was regarded as the complete antithesis of competition.

The ways in which business came to be conducted during the twentieth century accorded with neither concept. Classical theory was unprepared for the newcomer. When it tried to fit the methods of managerial enterprise into its framework, it explained them either as variants of monopoly or of free enterprise. One school started with monopoly and then watered this down to semimonopoly and monopolistic competition. The other started with free-enterprise competition and graded up to imperfect competition. The in-between stages have characteristics of both. They overlap but are still considered variants. Monopoly is said to merge into duopoly and oligopoly whereas the dismaying terms, monopsony, duopsony and oligopsony describe control by the buyer rather than the seller.

A search for the particular characteristic that might be singled out to identify monopoly started. The vehicle was the interpretation of the Sherman Anti-trust Law. Many characteristics were tried. Mere size, power, misuse of power, and restraint of trade, reasonable restraint of trade, decrease of competition, combination, price collusion—each had its day. And each has validity but only in some degree. Size is one thing in the steel or chemical industries and another in the shoe machinery industry. It may be measured in dollars or in the share of production one firm has of its industry. An industry itself is a vague concept, with disputable boundaries.

Restraint of trade may be stretched to include any conventions or acts that might lead to lessening pure competition, though they be far from constituting monopoly. Reasonable restraint of trade comes nearer the mark, but raises difficult problems of interpretation and evaluation. Combi-

nation may apply to any amalgamation or absorption of one concern by another. Collusion is hard to distinguish from following the leader with respect to prices or even from a coincidental fixing of identical prices. Of late, the emphasis has been on the conspiracy and it at least has the advantage of being more understandable. But any agreement no matter how innocent, or any trade practice no matter how common, may be stigmatized as a conspiracy.

Though hard to define and difficult to isolate, monopoly is a reality that cannot be dismissed. The concept must be reassessed in the light of modern business practices. Monopoly may be said to exist when a concern or group has trade advantages of such power and permanence that they will not be destroyed if they are employed to exploit the public. Up to that point, the concern or group has merely a more or less permanent and powerful trade position. The test is a matter of broad judgment as to whether as a practical matter the potential customer has any real choice. How does this definition stand up when applied to public utilities?

A city subway, suburban bus line, or an electric or gas company has its customers ready at hand. If uncontrolled, it need only study the extent of demand at various rates and then set rates in its own interest. Railroads, telephone and telegraph companies are largely though not entirely in the same category for other forms of transport and communication have cut into their former monopoly. Each has the power of a franchise behind it. Monopoly exists also when there is complete ownership or control of an essential raw material or of a group of patents. Out of such circumstances power may come into being which can be exploited with

impunity. Less important and ranging down to the trivial, are local trade positions that are susceptible to exploitation and unique small organizations in the interstices of commerce. In none of these situations do potential customers have any real alternative. The sole trader on an inaccessible island or the company store in a remote mining town may have such a pocket monopoly.

The classical concept of monopoly price was as simple as that of monopoly itself. It was the point at which demand and supply met to yield the highest gain. Today this is described as the price that maximizes profit. However, the exact point at which profit is maximized is not as definite and fixed as the classical formula apparently establishes. The demand curve for any article cannot be determined in the abstract. It must be felt for by actual experiments. Indeed, it is not a curve or at least not a smooth one, but a series of steps or jumps. A lowering of prices does more than stimulate existing demand gradually. It opens up new sources of demand.

Thus when electric current can be bought cheaply enough it is used for cooking, power, and heating as well as lighting: Possibly the utility company can set two rates, each geared to the maximum demand for the use to which the current is put. Sometimes a sliding scale can be offered so that the rate is reduced automatically as the amount used increases. When neither is practicable, a single rate is set as a compromise. Controlled experiments to discover what the actual use would be at various rates are difficult to perform, and require assumptions concerning the number of machines, stoves, and gadgets that would be purchased if rates were lowered. In a static economy such computations

might yield reliable guides but in a dynamic economy they can scarcely yield more than intelligent guesses. In spite of the complexities, when unregulated monopoly can be said to exist today, its prices are still set much as they were under the classical method.

The methods of managerial enterprise and of monopoly are poles apart. Managerial enterprise must ever look after the advantages that constitute its trade position. It must offer products, terms, and prices that attract customers as widely as may be. Its customers have a choice. They can come to it or go elsewhere. They can buy or refrain from buying. True, managerial enterprise has power but it loses that power if it abuses it. As a rule prices tend to go down, not up.

Macy's and Gimbel's in New York City are a pair of managerial enterprises unique only in the dramatic aspects of their relations. Each has a strong trade position yet neither is a monopoly. Indeed in some ways their competition resembles that associated with free enterprise. At times their rivalry is emphasized in the public mind by a price war on some particular article and advertising that seems to be aimed at the other. Yet each has a clientele so devoted that it will not shop elsewhere—not for all types of goods, but for certain lines. Each has fields in which it is recognized to be especially strong. Moreover, in deciding upon policies, prices, and actions, each has to consider the pulling power of other similar stores. Not merely that but each must consider the advantages offered by unlike types of distribution, local, specialty, and chain stores.

In certain respects Macy's and Gimbel's have mutual interests, for they are almost side by side. Together they form

a shopping area which as a whole is in competition with other shopping areas in New York City. Either would suffer a net loss were the other to move away. Both might welcome a new powerful distributor in their midst for it would bring more customers into the area and to them than it would take from either of them. From this angle they might find it wise to help a newcomer. To one thoroughly imbued with the free-enterprise philosophy this would be incomprehensible and would smack of the sinister. Theirs are not the methods of monopoly or of free competition, nor can they be made consistent with either. They are the methods of managers seeking trade advantages.

Altman's and McCreery's were not benefited by the lessened competition when Best's moved uptown. Quite the contrary, since the area now has less pulling power, their trade position is so much the poorer. It is not power as such that constitutes monopoly, but the ability to exploit that power. But what is exploitation? Profits do not provide the answer, for only in part are they dependent upon price. Indeed as has been demonstrated repeatedly in industry, low prices and high profits often go hand in hand. High-priced concerns may well not be blessed with high profits.

Nor is the rate of profits a reliable test of exploitation. For after the elusive profit has been pinned down, there remains to be faced the formidable task of calculating capital value. Market value cannot be used, for it is a reflection of estimated profit. Capital value must be looked for in original investment, replacement cost, or book value. Each has its validity for certain purposes. Original investment is applied mainly to public utilities. The inherent difficulties are multiplied in the case of manufacturing concerns. Even if a fig-

ure could be agreed upon, it could scarcely be a criterion of exploitation.

Replacement cost would seem to have possibilities. For physical properties it can be estimated but the methods vary widely. The largest scale attempt ever made was in the case of the railroads which was begun in 1915 and carried forward into the twenties. Estimates before and after depreciation are used by the Interstate Commerce Commission when rate increases are requested. Intangibles, which are more important in other industries, are especially hard to evaluate in terms of replacement costs. Patents, good will, a going concern, mineral deposits, constitute a major part of capital value in many cases. They cannot be replaced and consequently their value must be found by the roundabout method of estimating their contribution to future profits. Replacement cost is appropriate to determine the amount of insurance that should be carried, but it is not so well suited for computing a rate of profits.

The merit of book value is confined to its definiteness. As a fixed sum carried on the balance sheet, the book value has historic significance. From it annual income can be estimated, but it is of little help in defining exploitation.

Though theoretically indefensible, profits above some normal rate might be the criterion for exploitation. This was the measure for determining excess profits in wartime. Its chief merit lay in the fact that it produced a figure on which the tax could be assessed. Injustices were known to be temporary and were borne along with the other tribulations of war. Special cases were accorded special exemptions. But for determining the fact of exploitation, profits above a normal rate depend upon one's definition of "normal." Any

year or series of years may be used and the normal rate will vary accordingly. While 1936-39 were as good as any for assessing excess profits taxes, they are just as unsuitable as any other years would be for the crucial business of serving as a test of exploitation.

High or low prices isolated from other economic factors would likewise fail to provide an adequate criterion for exploitation. An administrator is seldom confined to one price. The price he chooses is the one he thinks will contribute to a balanced operation in view of the other factors he must take into account.

At first glance, the obvious way to increase profits would seem to be to raise prices. But the effect on demand must always be considered, and it may well be found that demand falls off. To reduce prices in the hope of uncovering new areas of demand requires courage and sagacity beyond the ordinary. Involving many adjustments other than the price itself, it is a risky operation and its full effects may never be known.

The question is often discussed whether power as such, and to what degree, constitutes the problem, or whether it is the abuse of power. Managerial enterprise may use its power so wisely and moderately that its extent is hidden. Nevertheless, the power is there. This power of management is great and in a democracy management should properly be held accountable for its use. It encompasses far more than the purely business aspects. It enters into the national economy and the social fabric. Management cannot legitimately plead the philosophy of free enterprise, upon the theory that its every act is regulated by an impersonal market over which it has no control. The facts are obviously to

the contrary. Though management's power is not unlimited, it has some degree of control. Monopoly begins when control is absolute.

How far the policy of the Department of Justice is from the realities as they are here described may be gathered from the following excerpts from a recent speech by a member of the staff endorsed by the Attorney General. In performance of its duties the Department quite naturally seeks an ideal of competition and it considers that the individual entrepreneur should have no choice in the matter of price.<sup>1</sup>

In a great American industry with standardized, supposedly competitive products, no producer under the theory of competition has the right to be in a position where he can decide whether his policy shall be one of high prices and restricted production or low prices and high production. The very conditions of choice assume a considerable degree of monopoly or tacit agreement among competitors. If the industry is truly competitive, he has *no* choice in the matter. He will do like the farmers do—produce as much as he can and sell at the market price.

From the point of view of antitrust enforcement, the only way to bring about a reduction in the power of price leadership is a long and expensive series of dissolution suits, so that four or six or eight companies will not control 70, 80, 90 or 100 per cent of an industry.

In the field of domestic trade and commerce there is

<sup>1</sup> Address by George P. Comer, American Economic Association, *Papers and Proceedings*, 1946, pp. 158, 170. Concerning this Attorney General Clark writes under date of March 26, 1947: "The quotations which you refer to from Mr. Comer's speech are in harmony with the policies of the Antitrust Division."

a chance that competition will win out if supported by American businessmen who believe in competition and if the game is policed by a vigorous enforcement of the antitrust laws.

The Department complains that Congress has denied appropriations sufficient to carry out its purpose. Only enough is voted to give the Antitrust Division a nuisance value. But this is not the important point to be considered. It must be borne in mind that the philosophy behind the Sherman Act dates from our economy of 1890. Since then a great deal of water has passed over the dam and the really important point is this. In this philosophy there is no glimmering of comprehension of the later developments and the current existence as well as the intrinsic advantages of administered prices, which very definitely are not the prices which result from an open market or any type of auction. While administered prices are named in advance as an integral part of a system of production and distribution, the situation may be a long way from monopoly under any tenable definition. A widespread effectuation of the theory of the Sherman Act would mean the breakdown into minute units of all those segments of industry which we call managerial enterprise. With this would come the complete disorganization of modern business.

Courts have struggled to apply specific tests for monopoly, sometimes embedding their economic judgments in legal phraseology. The oft-quoted Standard Oil and Tobacco cases of a generation ago broadened the scope of inquiry and led the way to the rule of reason. The Aluminum Company of America (ALCOA) case, a more recent example, presents many facets of the differences between the opera-

tion of managerial enterprise on the one hand and either free enterprise or monopoly on the other. The story as related here is taken mainly from the opinion of Judge Learned Hand, in which he portrays the situation with respect to the production of aluminum ingot before World War II.<sup>2</sup>

ALCOA was an exceptional company. It was not a product of competition but had started from scratch. As a matter of fact there had never been any competition in aluminum itself. What there was in the way of competition was in steel alloys, nickel, and copper. Moreover, until its patent rights expired in 1909, ALCOA occupied a monopolistic position which was entirely lawful by virtue of those patents. The company also owned a preponderance of the bauxite deposits from which alumina is made. It owned also water-power sites, factories for transforming bauxite into alumina, and a considerable proportion of the factories that made the finished product. Its personnel had grown up with the business and was highly skilled. Through patent arrangements with foreign manufacturers it enjoyed preferential rights for processing. By means of cartel agreements, foreign manufacturers were to all intents and purposes excluded from the American market. As a result of these understandings going back many years, it had a series of powerful trade advantages.

The Department of Justice had attacked it on the ground that it was a monopoly. The Judge of the District Court had come to the opinion that these advantages were neither powerful nor permanent enough to constitute a monopoly and that they were simply sufficient

<sup>2</sup> U.S. 148, Fed. 2d 416.

to sustain the continuity of the organization. Finding no evidence of wrongdoing, he dismissed the case.<sup>3</sup> An appeal was taken to the United States Supreme Court. Since a quorum of that court was lacking because four of the justices disqualified themselves, the appeal was referred to Judge Hand's court in the Second Circuit.

Judge Hand too found no evidence of willful wrongdoing. Each trade advantage ALCOA had built up was in itself proper and the profits that had been made in the course of the years were not excessive. Nevertheless, its practically entire control of the ingot market appeared to him so great and so permanent as to constitute a monopoly. He was then confronted by the problem of legal relief. Meanwhile conditions in the industry had changed. During World War II the aluminum industry expanded tremendously. In the main, the expansion was financed by the government under agreements largely with ALCOA but also with the Reynolds Metal Company to manage the new plants on a fee basis. As the government now owned a preponderance of producing facilities, the future form of the industry would be shaped by the disposition it made of these properties. Any remedy that might bring about competition in the industry must await the action of the government. Hence so far as dissolution of the company was concerned, the case was simply reversed and sent back to the District Court to await those developments. Other relief was granted.

With the end of the war the problem has shifted to the disposition of these plants under the guidance of the Department of Justice. ALCOA was a willing bidder and other companies unwilling bidders. ALCOA also offered to sell at

<sup>3</sup> 44 Fed. Supp. 97.

prices approved by the government. This offer might be interpreted as an admission of continued monopoly and a willingness to submit to control. In any event, the offer was rejected. Disposal of the properties therefore proceeded under the greatest difficulties. In view of the powerful trade position enjoyed by ALCOA, potential competitors were chary of purchasing a plant outright at any price in the face of an unknown but certainly smaller demand for aluminum.

Acting under the mandate that the properties should not be disposed of in such a way as to create monopoly, the government leased certain plants to Reynolds and the Kaiser interests (The Permanente Corporation) on seemingly very favorable terms. A clause permitting cancellation after two years was written into the lease of the McCook plant to Reynolds and an option to buy it after a stated number of years was granted. This plant has all the latest improvements and was probably superior to the older plants owned by ALCOA. It is estimated that at present ALCOA is left with about one-half the producing facilities of the industry, Reynolds with about one-third, and Kaiser with the remainder. Whether this division will induce free competition remains to be seen.<sup>4</sup>

The trade position which management is always seeking to extend and solidify may become so strong that it can impose onerous terms and exact exorbitant prices. Monopoly in the sense of power to exploit can be attained, especially

<sup>4</sup> War Assets Administration Report to Congress, Feb. 12, 1947, First Supp.

in derivative services. Pocket monopolies are ubiquitous. But the road between managerial enterprise and monopoly is not one way. Tendencies run in both directions. An apparently secure monopoly is subject to erosion. It requires such an extensive organization and capital equipment that it cannot help becoming frozen. It cannot always utilize or adjust itself to new methods or processes. With a shift in demand or some new device, the monopoly of last year with power to exploit, reverts to a strong trade position without power to exploit.

The point at which trade advantage is so great that the purchaser has no choice is a practical question. When confronted with it some judges have displayed keen insight in their analyses. However the only remedy prescribed by the statutes is a reversion to competition which is a doubtful cure. An industrial court instituted both to define monopoly and prescribe appropriate remedies might be effective. Its functions would be to distinguish between monopoly and trade advantage; to classify each industry and assign it to the form of economy to which it belongs; to apply such control for monopoly and establish such codes for managerial and free enterprise as would enable them to meet the necessities of operation and pass on their benefits to customers. With the experience it could gain, and the cumulative value of precedents it would set, it might be expected to accelerate and ease the process of adaptation to the incessantly shifting forces of our dynamic economy. However, such administrative procedures have their definite dangers. More in line with our traditions is an overhauling of the Sherman Act by legislative methods.

## CHAPTER

# 11

## Impact of Managerial Enterprise on Free Enterprise

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PRODDED BOTH BY necessity and a search for advantages managerial enterprise has devised new and distinctive ways of doing business. Peculiarly American it has grown steadily until it dominates the vital half of our economy. Its impacts on the social life of the country have been correspondingly extensive and deep. To it can fairly be attributed the great productivity and the high standard of living in the United States—which surpasses by far anything accomplished in any other country in any era. Carl Snyder has glorified it in his *Capitalism the Creator*.

Managerial enterprise is at once more complex and more difficult to operate than either free enterprise or monopoly. Its functioning impinges on all its members adding a new series of strains. The tensions and anxieties of management are wearing. So complicated is the intermeshing of the various parts that one or another is constantly slipping out of gear even under favorable conditions. Under disturbed conditions such as the reconversion from war to peace or

during the first or last phases of a business cycle, this tendency of affairs to go askew is intensified.

There has been little, if any, of what might be called normal conditions since 1914. The dynamic effect of new inventions, changing tastes, fashions, and alterations in the purchasing power of different groups compels management to a frequent reappraisal and readjustment of its methods, techniques, and products. There is no such thing as standing still. An organization either improves or retrogresses, and often it is more difficult to regain a lost position than to attain it in the first place. New plans must always be in the making and be put into effect even while the present plans are still maturing.

These strains are not compensated by immediate tangible accomplishment. The joy of attaining a definite goal has been submerged in the vastness of space and time. Management must learn to get its satisfaction vicariously, trusting that its contribution will sometime fructify to the benefit of the community as well as to the enterprise. It has no single limited objective that it can perceive, measure, and take pride in achieving. Its goals are multiple and are judged by criteria other than dollars and cents.

The strains on employees are equally as great and their satisfactions equally attenuated. They are not free to come and go as they please nor do they see the results of their work. They must adjust their lives to the necessities of others, often persons unknown to them. They must start and stop work at a given moment and accomplish their small bit unfailingly and on time. They are under constant pressure to hurry so as not to stall the whole operation. Instead of having the satisfaction that comes with a com-

pleted job, they must be content with performing a minute operation in a coordinated functioning. Their products once finished are sent on their way to unknown destinations to be sold and used in distant places by persons with whom they never have contact. Here, too often unperceived, is a potent contributory cause for labor unrest.

By nature, managerial enterprise is impersonal. Decisions are made by groups and not by individuals. Only the chief executive can express his personality and he does so by putting his imprint on the system rather than by determining particular policies. He is a catalytic agent, not a doer, and the inspiration to action rather than the source of decisions. The officers and employees reflect the chief as mirrors reflect light. Managerial enterprise requires a cooperation unknown to free enterprise. Consequently loyalty is at a premium. But the loyalty that is inspired by an impersonal institution is focused on the work, on getting the job done. Lacking the selflessness inherent in loyalty to ideals or persons, it lacks its intensity. Divided between allegiance to the whole and to the group of which the individual is a member, it fails when self-interest or a personal loyalty intervenes.

Efforts are made to stimulate and nourish loyalty by personal touches, which enhance the status of the employee and emphasize his individual contribution. Displays of the finished product, moving pictures of the entire process, pep talks on the significance of each subdivision, rewards for performance above a quota—all these are matters of routine in a well-administered business. The importance of the product to customers, the pleasure it gives and the use to which it is put are explained. Many concerns have monthly

magazines in which they personalize employees and units with pictures and social notes. The efforts are well intentioned but the results too often disappointing. Their objective is to persuade employees to surrender some of their personal liberties voluntarily.

In comparison to the liberties that must be surrendered in the collectivist industries, those which are given up in managerial industries are relatively unimportant. Exactly what liberties are given up, and how far, is the controversial issue. Freedom is a question of degree. The complete freedom to come and go, not to turn up, or to quit without notice, is incompatible with the smooth functioning of any organization. Individuals, even the most important, can be replaced without materially affecting the whole. But stoppage by any group, even the smallest and apparently least important, sabotages the works. Witness the devastating effect of the 1946 delivery strike in New York City initiated by a group isolated from the rest of the distributive system. Some of this loss of freedom is compensated by the added security managerial enterprise gives. Grudgingly and slowly management has relinquished its original right to hire and fire at will. Increased steadiness of employment, insurance, pensions, accident and sickness benefits are now the rule rather than the exception, though the struggles by which they have been won have left scars.

Abuses in managerial enterprise occur principally for three reasons. The system is not clearly defined but is in many cases hybrid and the border lines between the different forms of economy are shadowy. Secondly, no accepted codes have been formulated. The adaptations of and exceptions to the current codes of free enterprise produce surpris-

ing and extraordinary results. Finally, depending as it does upon cross-checking, managerial enterprise cannot protect itself when collusion causes its safety devices to break down.

Very few of the accusations brought against managerial enterprise are due to its methods of operation. They stem rather from the misapplication of the criteria of free enterprise. Abuses are at best hard to define. Arrangements that from one viewpoint seem natural and desirable methods of meeting a given situation can be branded as pernicious. The hybrid forms, with some characteristics of both free and managerial enterprise, are an especially fertile field for abuses.

Managerial enterprise affords many recesses into which free enterprise can fit itself and flourish. It touches both free enterprise and collectivist industry, overlapping at many points. When any two of them overlap there is ample opportunity for manipulation, since each form operates under different principles.

At many points of personal contact managerial enterprise can be utilized for personal gain because codes of behavior are either lax or lacking. Most lucrative is the inside knowledge a director possesses that enables him to make private deals in advance of the publication of news. So great was this advantage that men eagerly sought directorates with no other purpose in mind. The exploitation of this privilege reached such proportions as to create a major scandal and was one of the chief reasons for the formation of the Securities and Exchange Commission. It published a set of rules requiring directors, officers, and owners of 10 per cent or more of the capital stock to report the number of their

shares, their purchases and sales. But 9½ per cent ownership gets in under the wire. Directors having no personal interest often represent the real owners. Such maneuvers cannot be covered by any rules.

As recently as 1928 Sumner H. Slichter, in his *Modern Economic Society*, was able to say that managements were appointed by the stockholders.<sup>1</sup>

They are not free men. They are not neutrals, hired to serve all interests alike. They are employed by stockholders to promote the interests of the stockholders.

Such a judgment could scarcely be made today.

In another connection, he pointed out:<sup>2</sup>

Of very great importance is the possibility that the professionalization of management will lead to the development of professional standards and that managers will be governed in their policies by these standards as well as by the desire to make profits for business owners. It has already been suggested that if standards could be made to reflect the interests of the community, the professionalization of management might become an important instrument in the social control of business. Experience with professionalized management is still too scanty to afford a satisfactory basis for prediction.

A recent study by Robert A. Gordon<sup>3</sup> emphasizes the diversity of interests that play a part in decisions and busi-

<sup>1</sup> Slichter, Sumner H., *Modern Economic Society* (Holt, 1928), p. 887.

<sup>2</sup> *Idem.*, p. 145; cf. p. 726.

<sup>3</sup> Gordon, Robert A., *Business Leadership in the Large Corporation* (The Brookings Institution, 1945), p. 47.

ness leadership. He concludes that stockholders are the least important, describing them as those

who are nominally responsible for selecting directors, but who in practice may have no influence in choosing them or in making any other important business decisions.

Stockholders have a minimum of influence in selecting directors and the relations of directors to officers are not clean cut. Technically the directors select the president and other officers. Actually, the president is influential in the selection of the directors. Opportunity is rife for cross favors at the expense of the company. Directors set salaries and other terms of employment. When there are directors not active in management, they are usually constituted a committee to make such determinations. The other parties at interest are not represented. Only the fine sense of discrimination of those concerned prevents their taking advantage of such opportunities. Salaries are often considered excessive by critics who do not appreciate how scarce are men competent to administer the complex affairs of managerial enterprise. Able executives are literally priceless.

Professional men serve managerial enterprise as individuals at many points. Accountants vouch for the accuracy of its statements. Lawyers advise and defend its acts. Architects, engineers, and contractors supervise its new construction. In these fields the codes of professional ethics are so well understood and respected that no one oversteps the boundaries. When, however, professional men join managerial enterprise their professional ethics are subjected to great strain. They may lose their objectivity. Even when the

relations are only semipermanent their codes may be sacrificed. Law firms retained as general counsel are constantly under criticism justly or unjustly. On the ground that independence may suffer through long contact, there is a strong sentiment in favor of changing auditors from time to time rather than to re-employ the same firm.

No managerial enterprise can safeguard itself against the connivances of strategically placed individuals. Collusion vitiates any series of checks that can be devised. The McKesson and Robbins incident, where three brothers under different assumed names formed an inner ring to rob the concern, was not preventable by any ordinary method of auditing. Petty thievery can be accomplished at many points—in handling cash, in letting contracts, and in accepting favors. The story goes that a china buyer of a wholesale concern in looking over a manufacturer's line especially admired a certain pattern. The manufacturer offered to send him a set as a present. "Oh no," protested the buyer. "I could not accept that. We have a rule in our firm against gifts." "Well, we can fix that," rejoined the manufacturer, "I'll send you a bill for a dollar." The letter of the rule had been kept.

A conspiracy involving an outside customer who orders goods, the salesman taking the order, the delivery man on the route, and the receiving clerk who falsely vouches for the return of the articles after they have in fact been delivered and kept, may go on for months without detection and run into large amounts. A similar conspiracy including a fake manufacturer who sends bills for goods alleged to

have been delivered, the receiving clerk who falsely vouches for their receipt, and the treasurer who pays the bills to the ghost manufacturer, cannot be detected by the routine examination of auditors. The shortage will not be noticed until suspicions are aroused by a slip. There is no telling how much is never discovered. Such jobbery however can scarcely get away with enough money to cause bankruptcy. Persons familiar with affairs are likely to notice discrepancies that cannot be explained. An intense check-up directed at the focal point reveals the collusion. But as it is impracticable to scrutinize all operations meticulously, fraudulent and collusive action has considerable scope for its operations.

Managerial enterprise is inevitably honeycombed with intertwining ownerships. Holding companies frequently own a partial interest in the operating companies, the remainder being owned by the public or a few individuals, or another enterprise. Conflicts of interest in such intercorporate dealings are unavoidable, and must be handled with great circumspection. Even when there is no actual fraud, justice is difficult to administer. Partial ownership of competitors or customers often leads to preferential arrangements. Stockholders or certain individuals among the management may have independent interests that are served by such internal relationships. Charges are easy to bring and they may be sustained. In any case they are hard to refute even though the acts may be quite correct. When single acts are plucked out of the complex setting oftentimes they can easily be made to appear as if done in bad faith. This is a characteristic of the strike suit. For example, in deciding

the case of a stockholder who had alleged misappropriation, the Supreme Court said:<sup>4</sup>

For aught we can see to the contrary, they (the complainants) may have purchased their shares long afterwards expressly to annoy and vex the company in the hope that they might thereby extort, from its fears. . . . Unfortunately, litigation against large companies is often instituted by individual stockholders from no higher motive.

In politics the swapping of favors is more common. It is part of the game, whereas it is not so regarded in business. Moreover, in politics opponents are equipped with the machinery to clear themselves if they are investigated. In business on the contrary, the ramparts of defense are neglected. Except for examinations by certified accountants and internal audits, there is no regular system of inspection. When an investigation is started, often by a Congressional committee but at times in litigation by stockholders, management is unprepared. Dusty files and letters are requisitioned and innocent phrases lifted out of their context.

Managerial enterprise functions with aggressiveness but not effectively in self-defense. Were it to adopt the self-protective methods government agencies have come to find necessary, its efficiency would be impaired. It cannot meet the attacks of government, labor unions, and crusading stockholders on their own ground. When called upon to justify its acts, it is often outwitted. In addition, executives are inarticulate and are just beginning to sense the need for

<sup>4</sup> *Dimpfell vs. Ohio & Mississippi Railroad Co.*, 110 U.S. 209.

public relations counsel. They do not recognize the value of headline news.

In conducting public hearings on the methods of management, it is a well-known trick for the prosecuting attorney to shoot an embarrassing question to a witness at the close of a session. The question, cleverly phrased to give it news value, breaks page one of the morning papers. Then the public gets the impression of hidden plots and wrongdoing. The witness is put on the defensive. He usually lacks the skill to express himself in such a way that his answer the next day will also be news. He spends the evening phrasing a meticulously accurate answer, which is so dull that it is reported on an inside page.

When a few large enterprises are the purchasers of raw materials from a large number of small individual producers, the natural advantage of the buyer over the seller is enhanced. Such transactions often take place through nominally free auctions. But these auctions are not as free in fact as they are in theory.

In the tobacco industry a few managerial enterprises buy their raw tobacco at auction from a host of free enterprise farmers. Their decisions are based on long-term policies that affect the market. The individual decisions of the farmers spring from exigency and opportunism. And have no effect on the market. Here is a clear example of the two forms of economy meeting. These tobacco prices are determined neither by a truly free auction where everyone is expected to look out for himself, nor by a wisely administered process, which gives full consideration to future

relations. As a consequence they are distorted and the buyers are accused of exercising a monopoly power. The Department of Justice steps in to file an action based on the Sherman Act and the code of free enterprise.

Just how confusing the explanation of motives has become is indicated by the following choice bit from the opinion in the American Tobacco case:<sup>5</sup>

All appellants give the same reason for being obliged to follow a price rise inaugurated by any one of them—that if they do not follow it, the others will have more money to spend on advertising. But all of them also explain that they must similarly follow a price cut or will lose business through sales, as otherwise the cheaper priced cigarettes would completely outsell their products. These explanations are patently inconsistent. . . . It would be contrary to common sense to say that the jury could not draw inferences, from the price changes and appellants' methods therein, that they all conspired and agreed to raise or lower prices simultaneously, and that they acted in combination, agreement, and concert in so doing. In this regard, appellants refer to the fact that it is not unlawful to follow *price leadership*. But, in answer to this argument, it may be remarked that "uniformity of price may be the result of agreement or understanding, and that an artificial price level not related to the supply and demand of a given commodity may be evidence from which such agreement or understanding, or some concerted action of sellers operating to restrain commerce, may

<sup>5</sup> *American Tobacco Co. vs. U.S.*, 147 Fed. Rep. 2d Sec. 114.

be inferred. . . ." The explanation given why all appellants must be represented at the same markets—and their refusal to purchase at a market where they are not all present—is that if one is absent from, or quits a market, the competitors would buy tobacco at a much lower price than the other had bought it, and that, for that reason, they try to adjust the amount of tobacco they buy so that the three appellant companies are represented on all markets from the beginning to the end of the selling season. They assert that they carry out this policy in pursuance of a duty which they feel they owe to the grower to give to the man selling last the benefit of whatever purchasing power the companies may have, in equal proportion to the man selling first. These explanations of appellants' conduct as being necessary to enable all the farmers to get the best prices and, at the same time, to prevent any one of the companies from buying tobacco at prices disadvantageous to the farmers—even if meritorious in fact—could not justify the violation of Sections 1 and 2 of the Sherman Act.

The market for meat is no less confused. Meat is sold by a great number of producers in the main to a few large enterprises. There is one difference here however. Managerial enterprise in tobacco has longer range policies, for it carries several years' supply at various stages of maturing, whereas in meat no comparable stocks are maintained.

Many managerial enterprises distribute their products through free-enterprise retailers. Here again the respective interests are antagonistic though ordinarily the effects

are on the petty side. Opportunism determines the prices of the free enterprise retailers, and policy determines those of distributive systems. The policy of the latter frequently clashes with the policy of the manufacturer, especially in trade-marked articles. This incompatibility of interests became so serious at one time that it led to the passing of the Miller-Tydings Act,<sup>6</sup> which gave the manufacturer the right to fix retail prices. The good aspect of this Act is that it fosters stability. The bad is that it permits a rigid price which may not meet the needs of the local demand situation.

Another interesting example of the lack of harmony between free and managerial enterprise was furnished some years ago by the experience of a large department store. It hired as the manager of its Far Eastern Department a trader who had spent many years in the Orient. He knew the merits and values of Japanese and Chinese works of art and ornaments. He was skilled in trading. He bought where he could—from friends, customers, other dealers, collectors, and at auctions. He sold as he could, at fair market prices and not at prices based on any policy. He exchanged articles whenever he considered this advantageous. He acknowledged the receipt of the goods on torn pieces of brown paper instead of the authorized forms, and ordered the controller's office to make payments without the prescribed routine. One evening he was detained by a store detective while he was carrying away a beautiful jade tree. Afraid to entrust it to the store delivery and wanting to be sure that it reached his customer undamaged, he had intended to take it to him in his own hands.

Following his natural bent of doing everything himself,

\* 50 Stat. 693; 15 U.S.C.A. 1.

he had run counter to the very policies upon which managerial enterprise is based. Though he had attained a distinguished success that brought prestige as well as increased profit, such untrammeled individualism could not be tolerated. His methods were incompatible with systematic merchandising. Records became impossible to keep. Exceptions broke up the routine, and gave others opportunities to claim precedents. Finally a parting of the ways could no longer be postponed.

Somewhat removed but similar are the methods of pricing goods produced by and sold to managerial enterprise, such as rayon and other synthetic yarns. Any change in price upsets the industry. Weavers, finishers, manufacturers of finished garments and retailers all try to protect their position. If a rise in price is rumored, they increase stocks on hand; if a decrease, they get rid of as much as possible. Weavers and manufacturers may even close their plants, waiting for the lower price. Protective clauses are put into sales contracts. Discussions are held to find ways of mitigating the bad effects of unstable price levels. Sellers, eager to hold the good will of their customers, want to throw the losses back on others. The repercussions move at different rates on different levels. Manufacturers react first, changing their prices immediately. Retailers, accustomed as they are to a percentage markup, keep the same price until the new goods begin to arrive. The curious result is that for a period there are two prices for the same or similar articles.

Rates for advertising in newspapers are set by contract. As the contracts terminate at different dates, the paper suggests a change in rate to only one advertiser at a time. But

each retailer is interested in any change agreed upon with any one other retailer, because when his contract terminates he will have to agree to this new rate. Thus all newspapers and all retailers are intensely interested in the outcome of each negotiation.

Each side has alternatives. A newspaper might change other advertising rates or the price of the paper. Retailers might increase their mail advertising or join together to publish a shopping news, or use the radio at the expense of newspaper advertising. But each knows that it needs the other. A tug of war takes place in which all independently participate. Acts that might lead to charges of collusion are avoided. The effects of the alternatives are discussed. Newspapers argue that they would be bad whereas retailers argue that other groups can better bear an increase in rates. Conferences are supplemented by telephone calls. Pressures are applied and resisted. Threats are made by each side and by individuals. Only occasionally are they carried out, though that has happened. The process has many of the aspects of collective bargaining. The managers are intelligent and they finally come to an understanding.

Some years ago this normal procedure was upset. At a meeting of New York retailers called to discuss an entirely different matter of mutual interest, a representative of one newspaper who had been invited to attend remarked that owing to the increasing costs brought about by the war, his paper planned to raise their advertising rates the next week. The reaction was spontaneous and instinctive. The retailers felt the etiquette of prolonged discussion had not been observed. One man said he would not stand for it. Another announced that he would cancel his contract and with one

accord they proclaimed that they would withdraw their advertising. When the higher rates were announced all except a few did withdraw.

Thurman Arnold, on the point of retiring as Assistant Attorney General in charge of the Antitrust Division of the Department of Justice, saw the paper with practically no retail advertising. He smelled a rat. Inquiry disclosed that a meeting had taken place and he charged a conspiracy. As their lawyers told the retailers that the charge was technically correct, they settled rather than engage in long drawn-out litigation in time of war. The tempest in a teapot was ended with a consent decree and a fine. Though the discussion method may bring an accusation of collusion, it still remains the best means of setting rates.

In its early days, managerial enterprise failed to recognize its immense social influence and acted as if it were operating under the codes of free enterprise. It took no responsibility for community welfare. In *Human Leadership in Industry* Sam A. Lewisohn holds that "much social unhappiness and industrial unrest are due to ordinary, slovenly management."<sup>7</sup>

Managerial enterprise is sometimes referred to as an industrial empire. To some degree this phrase is apt. Its employees are transferred from job to job and sent from place to place much as civil servants are. Many small and relatively isolated communities—the coal and copper towns, Hershey in Pennsylvania, Kohler in Wisconsin, and a host of others are largely controlled by the enterprise whose plants are there. The standard of living, education,

<sup>7</sup> Lewisohn, Sam A., *Human Leadership in Industry* (Harper, 1945), p. 104.

and health are subject to the methods and necessities of their local enterprises. For good or evil this impact on social life is tremendous and it cannot be brushed aside. In this respect, the power of managerial enterprise is akin to that of government.

Paternalism is galling to men who take pride in their independence. It evokes resentment. But regimentation is the essence of managerial enterprise, and the resultant paternalism is merely the attempt to ameliorate conditions. Indeed, the real charge against management is that it has for so long side-stepped its social responsibilities. Local plant managers were selected for their technical ability, without regard for their ability to deal with community problems. Not until recently has this subject received the attention it deserves. The American Management Association is particularly active in stressing an acknowledgment of these quasi-governmental responsibilities.

Management's defaults in these particulars brought the natural and to-be-expected results. Into this breach rushed the labor leaders and the politicians. Then wage scales, rules, and working conditions arrived at amid the pressures of this atmosphere served only to throw organizations out of balance, for they were made without sufficient regard to their necessities. During the war period, the necessary fine adjustments were also unsettled by the edicts of labor boards and political executives. From this disadvantageous position management now endeavors to extricate itself by creating with the cooperation of intelligent labor leadership codes and rules and practices through which employees may be enabled to realize their aspirations.

## CHAPTER

# 12

## Problems of Today

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THERE IS CONVINCING evidence that since 1890, production has increased tremendously and that the mainspring of this increase is in managerial enterprise. This new form of economy, which is not yet recognized in economic or legal theory, expresses the creative genius of the people of the United States and embraces one half of its industry. The other half operates either under free enterprise or collectivism. These have been so long with us that their methods are familiar. The codes and laws that have grown up around them regularize their functioning. Managerial enterprise is of such recent and creeping growth that its methods are not understood, codes for it are lacking, and adequate laws have not yet been worked out. Moreover in contrast to these other forms of economy, it is extraordinarily complex.

That a new form of economy has emerged has been sensed by some economists, but its mysteries do not seem to have been fully probed. In *The Pattern of Competition*,

Walton H. Hamilton made a beginning when he pointed out that<sup>1</sup>

Industry cannot be set down as the great antithesis between competition and monopoly. It holds far too much of detail and drama, of color and variety, to be crowded into a few simple molds.

The wide variations in the economy have generally been minimized. The attempt to squeeze unlike situations into a common mold is due to thinking in terms of inherited slogans. In an effort to attribute all economic activity to a single motivation, the complexities are shoved to one side. To quote Hamilton again:<sup>2</sup>

It is at the current level of our knowledge impossible to produce a map of our economy. A glib term such as capitalism or free enterprise belies the variety of the phenomena it professes to sum up. As the prevailing order has come into being, the new has come, yet the old has lingered.

To function effectively managerial enterprise requires a degree of voluntary cooperation among its several parts far exceeding anything contemplated in free enterprise. Large numbers of persons with diverse skills and abilities must be fitted into a harmonious whole. Their rights, duties, and rewards must be determined not merely from the viewpoint of the individual or his organized group but within a framework that makes for continuity of operation.

Management, inheriting from free enterprise its superi-

<sup>1</sup> Hamilton, Walton H., *The Pattern of Competition* (Columbia Univ. Press, 1940), p. 25.

<sup>2</sup> *Idem.*, p. 22.

ority in negotiating a so-called market rate of wages, exacted terms so obviously unfair that the labor union was accepted as the only effective counterforce. The upshot was not an impersonal market rate but a compromise between two opposing and mighty powers. When neither side has any alternative a bargain cannot be called "free." There is nothing constructive or enduring about settlements arrived at when both sides are weary and bitter after weeks or months of wrangling. They can last only until one side or the other feels it can push for new concessions. The concessions and sacrifice inherent in cooperation are at odds with the complete liberty of the individual so frequently stressed as an American ideal. When businesses can no longer count on the driving force of want, they must offer other incentives. They must have, and they must make clear that they have, the interest of employees at heart. Employees in turn must come to realize that their fate depends upon the success of the business. Present tendencies give little promise that controversy will be less in the future.

The cooperation that managerial enterprise requires goes outside its internal organization. A steady supply of material and the distribution of the product can no more be left to chance than can the continuous functioning of the organization. Long-term contracts with producers of raw materials and semifinished products, as well as reliable means of distribution, are essential. It is at these points that managerial enterprise is most vulnerable to attack and disruption.

So comprehensive are the implications of managerial enterprise for the community that discernment to foresee economic and social changes is an essential quality in manage-

ment. It must have latitude to make timely adjustments. The development of automobiles has indirectly caused the number of horses and mules to decrease from 26 million in 1915 to 15 million in 1940 and the output of carriages to decrease from 900,000 in 1899 to 3,600 in 1929, and even reduced the demand for grain. With the greater use of fuel oil, coal has become less important as a source of power production. Whereas in 1920 coal had produced 56 per cent of the power, in 1945 it produced only 50 per cent. Electricity has taken the place of gas and kerosene as the mainstay of lighting. The history of the chemical industry is a succession of new products that are improvements on those already established. Management must be ingenious enough to contrive a series of arrangements that will reduce the losses from obsolescence in its wider implications. Indeed it was the helplessness of free enterprise with its small competing units in the face of technical advances that led to managerial enterprise. It alone has been able to turn the potentialities to account and to cope with the dangers.

As an example, take the flour industry. It was founded on selling flour to households by the barrel. Bread was baked at home once a week. Bakeries sold specialties that required equipment and skill not found in the ordinary household. Store bread was notorious for its staleness as the art of preservation had not been perfected and distribution was slow and expensive. By 1925 this whole scheme of things had been revolutionized by preservatives, wax-paper wrapping, and rapid delivery. Bakeries could offer their products at prices that made home-baking uneconomical. The General Mills Corporation led in the process of adaptation. While it continued to supply flour to bakeries, it set

up a new organization to market flour in the form of breakfast foods, biscuits, crackers and mixtures ready to bake. An extensive system of distribution was inaugurated. The costs were staggering but at last they bore fruit and the company gained new trade advantages to offset those that had become obsolete.

Frequently a managerial enterprise is unable to adjust to changed conditions. Then it loses its advantageous position. The very circumstances that are a help one year may be a hindrance the next. Whether the cause is complacent management or the relentless march of events, many companies lose dominance. At its inception in 1901 the United States Steel Corporation owned over 60 per cent of the industry but by 1945 that share had dropped to 40 per cent, owing in part to its failure to keep up with the demand for new alloys. The American Sugar Refining Company controlled about 90 per cent of the industry at the time of its formation in 1892. By 1927 it had only 30 per cent. The American Smelting and Refining Company dominated 85 to 95 per cent of the industry in 1899. In recent years its share may be estimated between 30 and 40 per cent. After Ford and General Motors had dominated the market for many years, Chrysler forced his way to a comparable sales level and the "big two" of the automobile industry became the "big three."

These are extreme examples. But minor shifts are ceaseless. Piecemeal adjustments to meet temporary misfortunes are apt to cause greater confusion and be more costly than doing nothing and waiting for better days. If the business is to refine corn and the corn crop is short, management can do little but bide its time and hope for a good crop.

Something, of course, can be done. Other grains can be used, but this is seldom worth while. Lack of sugar ties the hands of makers of candy, cakes, and soft drinks. A falling off of demand in other countries curtails the production of machinery, tools, and other exports. It is not solely a question of price. When products are not suited to the circumstances, they are not wanted at any price. In fact they often become a nuisance.

Yet free enterprise is too individualistic and collectivism too bureaucratic to adapt themselves to and to use technical progress to its fullest extent. Difficult as it is, managerial enterprise is the best fitted. The problems of managerial enterprise are not due as much to the nature of the organization as to the nature of the demand for its products. Articles having classical supply and demand curves fit easily into the free-enterprise economy. The inference that there is something wrong about administered prices because they do not fluctuate in the same way as agricultural prices is due to a failure to grasp the different rules under which the two forms of economy function.

It seems well established that in times of depression large enterprises suffer more than small ones. They are less flexible and their attempts to restore the lost balance take time. Investors and employees foot the bill for the large reserves which are essential. During 1932-33 the total payments of all corporations exceeded receipts, so that surpluses fell off. Given time and resources many large enterprises have successfully weathered the vicissitudes of business cycles for many decades. Their ability to plan ahead and adapt new inventions has progressively strengthened their position. And as large enterprises are frequently an agglomeration of

many small ones, individual losses are buried in the average.

Yet instances of great stability are equally striking. Mc Kesson and Robbins survived a scandal that rocked faith in business integrity. A prominent department store in Washington was seemingly untouched by charges of the Office of Price Administration. The Standard Oil Company of New Jersey has prospered through a series of changes in the oil industry that well deserve to be called revolutionary.

Managerial enterprise is at once rugged and fragile. At times it astonishes by its ability to survive overwhelming difficulties, at others it cracks under relatively light blows. Its flow of products surpasses that which either free enterprise or collectivism has been able to deliver. During the last fifteen years, it has withstood the attacks of government and individual critics as well as the ruthless caprice of natural forces and war.

It is a social organism and does not operate automatically. A rupture of demand will break the continuity of production and then the consequent rupture of production makes goods unavailable with the result that demand drifts off into other channels. After a war the reconversion period is prolonged by the extensive changes in the price level, in the distribution of income, and in the articles demanded. The intricate production network is dislocated, the channels of supplies are blocked and the system of distribution lies inert. Here free enterprise profiteers have their chance. The shifting price level creates confusion in the accustomed price pattern. Individuals reap gains in troubled waters. But the total income is smaller. Wages, dividends, and surplus are impaired. Temporarily, the economy takes on the chaotic characteristics of free enterprise.

In a free-enterprise economy, anyone could always try his luck elsewhere. Of course one was not completely free, as freedom depended upon the adaptability of one's skill and tools to other uses, but one always had some choice. Free land and ability to get to it furnished a final alternative.

The power and permanence of managerial enterprise render it liable to blame for anything. It is a natural victim of attack from all quarters. Emotions can be aroused against it. Its impersonality lends itself to malevolent caricature. Its immobility makes it as easy to hit as a sitting duck. It is sensitive to pressure groups. Any threat to the regularity of its operation calls for appeasement. Within limits, it can appease and still go on. Not so well perhaps, if the balance is seriously disturbed, but if balance can be restored, managerial enterprise may be bettered.

Food manufacturers fought the restrictions of the Food and Drug Acts bitterly. Yet few of them today would contest the salutary effects or deny that they themselves have been benefited. The shortening of the working day from twelve to ten to eight hours, and of the week from six to five days was regarded by many to place impossible handicaps on productive efficiency. Yet it was accomplished with apparent gain to business as a whole as well as to the individual employees. The service and entertainment industries have profited especially from the greater leisure of workers.

The right to strike was formulated and generally accepted under free enterprise. Distributed among many units the effects of a strike were confined to narrow circles. There was little danger to the economy as a whole. When employers and labor were unable to come to an agreement,

either side could leave the bargaining table and fight it out. Each, constrained by fear of the loss it would incur, kept its demands down to what it was ready to fight for.

But in managerial enterprise a strike is another kettle of fish. Its immediate effects are instantly more widespread. For instance a strike in what may seem like a subsidiary industry, such as roller bearings, may cause almost as great an upheaval as a strike in a key industry, such as steel, or in a monopoly, such as telephones or railroads. When employed today the strike has become a fearfully powerful weapon of bargaining, threatening not merely the welfare of the parties involved, but the welfare of the nation. Other and less disastrous means are available for ensuring a fair return to the employee. Strikes are as detrimental to the successful operation of managerial economy as they are to the working of a collectivist economy.

The philosophy of free enterprise has little to offer in the way of suggestions for keeping the power of managerial enterprise within bounds without impairment of its productivity. The power of the trade advantage is confused with the abuse of monopoly in which the end sought is to destroy the power. But in this process productivity too is destroyed. Its watchwords, tests, and standards were molded in a different environment with different ideals. Neither free enterprise nor government management can effect great productivity. In the stress of wartime, the former lacked the resources and the latter the experience to meet demands. The great managerial enterprises however, combining the requisite initiative and organization, delivered the goods.

The aluminum case already discussed is not unique except so far as it brings out in a peculiarly striking fashion the anomalies of imposing the free enterprise philosophy on an industry that by its nature is managerial. As constituted prior to the war, ALCOA was declared a monopoly. But the three units into which it has been divided by court decree, by the War Assets Administration, and by the Department of Justice, can scarcely be said to be operating under the codes of free enterprise. Meanwhile the industry is in the dark as to its future structure and its personnel does not know under what codes it will be expected to live. Uncertainties are inherent in all business. But when they are too numerous, they cripple operations.

One school of thought believes in restoring free enterprise competition:<sup>3</sup>

Any impairment of competition has the effect of prices and profits being held at higher levels, and consumption and employment at lower levels, than would otherwise exist with free competition under the same conditions.

and again:<sup>4</sup>

The functions of government in those industrial empires may at first be very small and relatively harmless, such as exchange of technological data. But inevitably the process of making profits by agreement tends not

<sup>3</sup> Ezekiel, Mordecai, "Is Government Intervention or Planning Consistent with Antitrust Policy?" in American Economic Association, *Papers and Proceedings*, Jan. 1946, p. 195.

<sup>4</sup> Kreps, Theodore J., "The Political Economy of International Cartels," *idem.*, 1945, p. 310.

only to destroy competition but to bring about an atrophy of enterprise in the generic sense of the term.

The Department of Justice in its vigorous application of the Sherman Act is implementing this belief in the intrinsic good of competition as such. Its lament is that it lacks the means to prosecute more than a fraction of the cases that operate under rules other than free competition. It has even gone so far as to attack regulated monopoly. In correcting obvious abuses, with the underlying philosophy of the Sherman Act which looks to the past, it only creates new problems.

More realistic is the observation of Robert A. Brady:<sup>5</sup>

Superenterprise co-ordination or "planning" of some type or other is everywhere on the cards; so far as the signs may be read at present, we shall see in the future only more of it, never less, . . . regulatory and anti-trust controls which ignore the inherently collective character of modern economic activity are ultimately doomed to failure.

Emphasis on unbridled competition as the sole alternative to monopoly appears to miss the possibility inherent in the new form of economy—managerial enterprise. Under it prices are not higher, but tend to become lower. There can be no atrophy of enterprise that is not paid for by the loss of trade position and consequent decline of business. The urge to improvement is present in managerial enterprise just as it is in free enterprise but it brings less immediate rewards. Management has its occupational hazards. The

<sup>5</sup> Brady, Robert A., "The Role of Cartels in the Current Cultural Crisis," *idem.*, 1945, p. 313.

early death of many business executives may be due to the strains imposed upon them by the peculiarly exacting nature of their responsibilities.

Managerial enterprise is a product of an evolutionary process. No blueprint of American business was drawn up in advance. Lawsuits that misapply monopoly criteria and legislation that stipulates free enterprise alone as a substitute cannot halt the trend. But managerial enterprise can be harassed again as it was in the thirties. It will remain subject to stalling until new standards of ethics are hammered out that will bring it public approval, and free it from attacks arising from fallacious analogies.

A philosophy of managerial enterprise will be evolved through the facing of such questions as:

- To what degree is competition in prices desirable?
- Can competition be forced to a point that is ruinous?
- Should production be regulated to coincide with consumption?
- Is division into smaller units desirable? Even if output will be sacrificed?
- Are the policies that lead to balance also those that make for greatest output?
- Is there a practical difference between actual agreement and a tacit trade understanding, such as "follow the leader"?
- How can the power of management be controlled?
- How should management be selected?
- Should government-owned corporations similar to the Tennessee Valley Authority be formed to serve as yardsticks?

Should government create competition by favoring the growth of rival enterprises, as in the aluminum industry?

How may prices be equably adjusted at the points where free and managerial enterprise overlap?

On all these questions much excellent work has been done and much thoughtful analysis put forward. But there is little agreement. Certainly if managerial enterprise continues to be regarded as a variant of free enterprise or of monopoly, little progress will be made. More might be forthcoming were it approached as a new form of economy. Possibly even then it would be found that industries are so diverse as to admit of little generalization. Yet some industries may resemble one another sufficiently to form a group to which a code can be applied.

The solution of these questions also requires the clarification of:

The standards by which industries should be classified as belonging to the free-enterprise, collectivist, or managerial form of economy and the interpretation of borderline cases.

The standards adapted to each form of economy.

The duties, rights, and responsibilities of directors and managers.

The duties, rights, and responsibilities of employees.

Safeguards to permit individuals to move as freely as possible among the different forms of economy.

Points at which the interest of the managerial enterprise and the national welfare are identical or antagonistic.

The policies under which business operates are much more significant than their acts, for the latter always depend upon some judgment of an executive in the interpretation of conflicting policies. While an individual act appears more important at any one time, its effect usually ends with it. By way of contrast, the effect of policies is continuous and the consequent trends are susceptible to analysis. It is possible that they may even be traced statistically. A combination of policies might be made the test. Low price, for example, or large output and progressive improvement of quality, or high wages and good working conditions, or again dividends sufficient to attract additional capital, and a surplus sufficient to assure continuity. From many sides there are signs that such policies and standards are emerging. As always, custom, concept, and law lag behind practice.

The ill-fated National Recovery Administration betokened a recognition that something had to be done about the chaos engendered by free competition. But the about face demanded by government was bewildering. The concept of industry codes, though basically sound, ran wild. The drawing up of each single code required wisdom and intimate detailed knowledge. They were however written in haste, sometimes on theoretical grounds by bright young men and frequently by representatives of industry in their own narrow interests. The failure was tragic for it obscured the many virtues of the principle.

The Securities and Exchange Commission is contributing to new standards. Individual institutions, as far as they are able, are adapting their own customs to a concept of morality commensurate with their position. The studies of

the Committee for Economic Development are leading the way in interpreting the new responsibilities business is being forced to assume. Edwin G. Nourse, now chairman of the President's Advisory Committee, made suggestions along these lines in his *Price Making in a Democracy*. Directorship is no longer taken lightly. In practice, it has become akin to trusteeship as contemplated by the law. The number of outside persons who are accepting paid directorships evidences the growth of a class that in time will evolve its own ethics and standards comparable with those that govern the professions. Management itself is rapidly becoming a profession attracting a new type of individual, one who tries to reconcile his business duties with his social obligations. The rate at which this type has grown in the past few years is promising for the future.

Formulating a series of codes and ethics that will fit the realities of business is beyond the ability of any individual. It can be done only through a long series of conferences and decisions, which while protecting the proven productivity of managerial enterprise, will make it responsive to public approval and conducive to social welfare. It is an heroic task. The rudiments of these codes have been indicated. Their adaptation to the variations and complexities of different industries raises a set of challenging problems.

It is a revealing commentary on the carry-over of free-enterprise philosophy that the conflict within industry is regarded as one between management and labor. However, as has been shown, management's actual position is as remote from ownership and stockholders as it is from labor. The struggle over a division of earnings is more accurately described as one between stockholders and employees. In this

struggle, management is neutral. But only in a sense, for management is responsible for a going concern and one of its objectives is a satisfactory distribution of income for all claimants.

Conflict in industry can never be eliminated. Nor is it desirable that it should be. Social forces never come to rest any more than other forces. Their relations call for an endless series of compromises. Industry has to keep adjusting itself to new conditions effecting changes of all kinds. It might be argued that management should always take the part of the underdog, so as to prevent the complete dominance of any one factor. Should one gain dominance, the balance would be lost and the business stagnate.

From a broader viewpoint the conflict between business and government is also a sign of health despite the apparent confusion and waste. Free enterprise is unable to stand up to government. Without power, it must submit to and adjust itself to any rules government sees fit to impose. In monopoly there is no balance of forces since government is all-powerful. Subjected to complete government regulation, monopoly becomes collectivism. Managerial enterprise alone has the strength to enter into conflict with government upon an approximately equal footing.

As codes of behavior are worked out and lived up to, the stability which managerial enterprise gives and the initiative it must exercise to hold its position may enable it to ward off the encroachments of harmful social forces. These two characteristics, stability and initiative, in proper combination, make managerial enterprise the form of economy that holds most promise of serving the manifold needs of our progressive society.

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